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Reducing the Deficit: Spending and Revenue Options

A Report to the Senate and House Committees on the Budget — Part II

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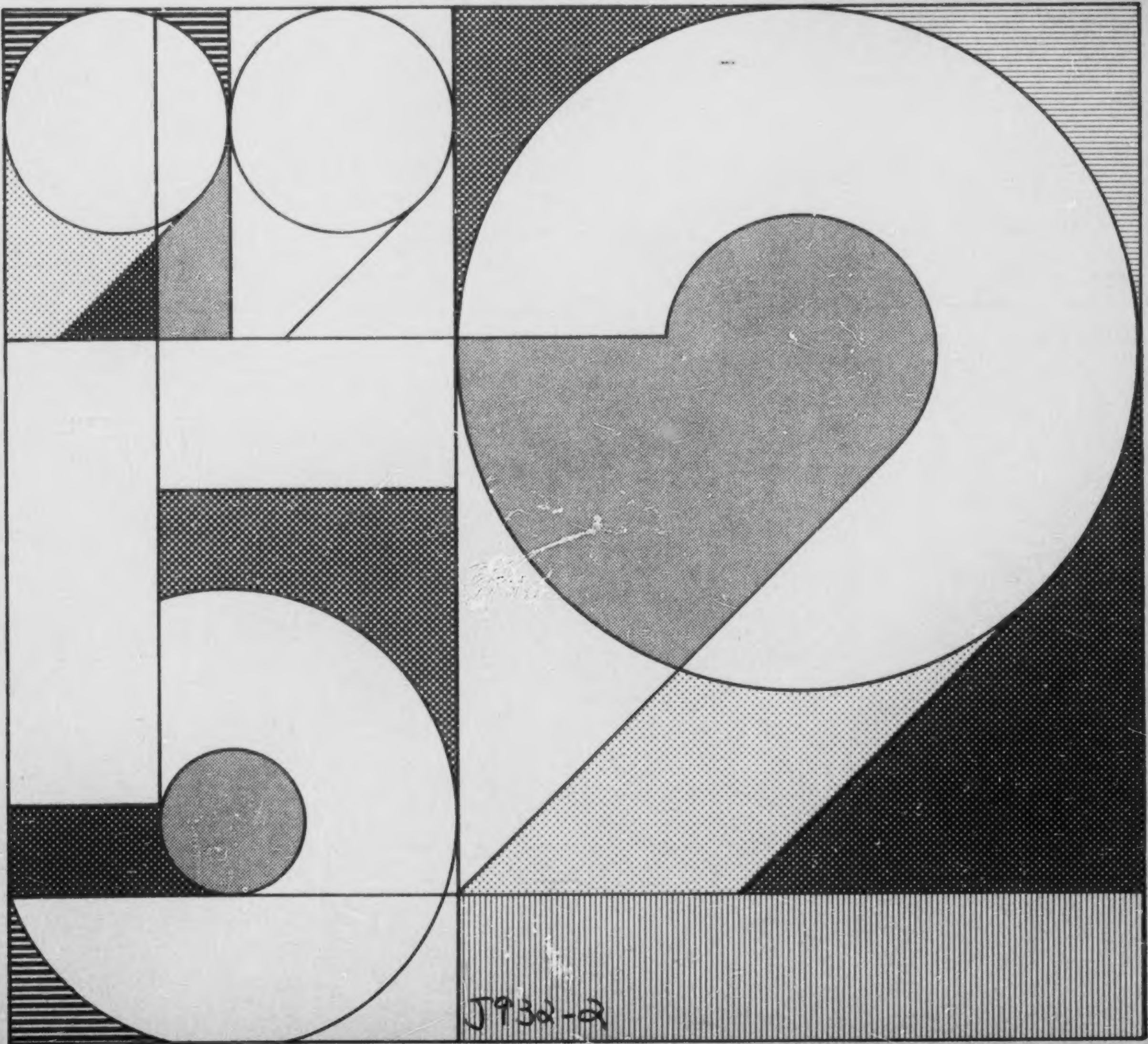

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1985 ANNUAL REPORT

REDUCING THE DEFICIT:

SPENDING AND REVENUE OPTIONS

The Congress of the United States
Congressional Budget Office

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Unless otherwise noted, all years referred to in this report are fiscal years. Likewise, unless otherwise noted, all dollar amounts are expressed in current dollars.

Details in the text, tables, and figures of this report may not add to the totals because of rounding.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the Senate and House Committees on the Budget. This year, the report is in two parts, with this report constituting Part II. Part I is entitled *The Economic and Budget Outlook: Fiscal Years 1986-1990.*

This report provides background information for each major spending area of the budget and for revenues, and analyzes various specific options that would reduce the deficit. The inclusion of an option in the report, or the omission of one, does not imply a recommendation by CBO. In accordance with CBO's mandate to provide objective and impartial analysis, this report contains no recommendations.

All divisions of the Congressional Budget Office contributed to this report, which was prepared under the general supervision of Robert W. Hartman. Alfred B. Fitt was responsible for Chapter I. John D. Mayer, Martin D. Levine, Mark E. Steitz, Sherri B. Kaplan, James G. Vertrees, Eric Toder, and Rosemarie Nielsen wrote various parts of Chapter II and were responsible for coordinating the specific deficit reduction options in Section II of this volume. Budget authority and outlay estimates were coordinated by Charles E. Seagrave, Robert A. Sunshine, Michael A. Miller, William P. Myers, and budget projections by Paul N. Van de Water. The Joint Committee on Taxation provided the revenue estimates.

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Director

February 1985

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SECTION I

INTRODUCTION AND BROAD ISSUES IN DEFICIT REDUCTION

CHAPTER I

INTRODUCTION

The Congressional Budget Office (CBO) projects federal deficits rising steadily from $215 billion in 1986 to $296 billion in 1990, if current policies are continued without change. The expected consequences of such large deficits--around 5.2 percent of gross national product (GNP) each year--are described in detail in the CBO report, *The Economic and Budget Outlook: Fiscal Years 1986-1990*, February 1985. Here CBO assumes that the need for deficit reduction is not at issue.

This volume attempts to provide a framework for considering strategies and paths to achieving better fiscal balance. It contains descriptions of a variety of alternatives, none of them clearly superior to all others. This chapter considers strategic issues, while more specific issues pertaining to major categories of the budget are dealt with in Chapter II.

The rest of the volume is a menu of detailed programmatic changes that would yield significant savings in outlays or increases in revenues. The menu is not exhaustive, even though it includes 88 options for reducing spending and 35 options for increasing receipts. The inclusion of an option does not constitute an endorsement or recommendation of it. The selection is meant only to illustrate major options for altering current policies in ways that would bring down deficits.

Each specific option is accompanied by brief arguments for and against it. A sampling of these discussions should convince the reader that there are no simple and obvious ways of painlessly reducing deficits. Virtually every proposal that would bring about significant savings affects people and institutions that would be hurt by the proposal. Nevertheless, unless such choices are made, current fiscal policies will themselves inflict long-run injury on a wide scale.

THE STARTING POINT

Actions to reduce the deficit must take as their starting point a federal budget that has evolved over time and that will continue to change even under current policies. The easiest way to see this is to examine the components of the CBO baseline budget. The baseline is an attempt to describe and project the outcome of current policies, showing where revenues come from and where spending goes. It also provides a useful starting point for considering the many circumstances that must be dealt with in a deficit-reduction program.

Composition of Spending

Spending programs have changed considerably over the past 20 years in response to the country's needs. The changes have been dictated by new priorities for defense, social welfare, foreign aid, space exploration, and so forth. This evolution has not been smooth over time; it has reflected the demands of war and the ideals of our society.

CBO's projection of baseline spending between now and 1990, if current policies continue, is shown in Table I-1. (The categories are explained in Box I-1 on page 6.) Total federal spending takes up about a quarter of the gross national product both at the beginning and at the end of the five-year period. But within the total there are major shifts:

- Net interest grows most rapidly in percentage terms, while defense outlays rise the most in dollar terms, the two accounting for 60 percent of all the growth from 1985 through 1990.
- Retirement and disability programs, though not growing quite as rapidly as GNP, still account for almost 20 percent of all spending growth.
- In the remaining entitlements, spending for health--Medicare and Medicaid--rises from 2.4 percent to 2.7 percent of GNP, while all the other entitlements (except retirement and disability) combined decline as a proportion of GNP, from 2.4 percent to 1.5 percent.
- Nondefense discretionary spending also lags GNP growth, falling from 4.3 percent of GNP to 3.8 percent.

Inasmuch as the defense and entitlement categories combined will make up more than 89 percent of the projected gross five-year spending growth (aside from interest payments) and will account for more than 82 percent of non-interest outlays in 1990, a significant spending-reduction plan that ignored those categories would entail a major redefinition of all other federal responsibilities.

TABLE I-1. COMPOSITION OF CBO BASELINE FEDERAL SPENDING (In fiscal years 1985 and 1990)

Budget Category	Estimated 1985	Projected 1990	Growth from 1985 through 1990	
	In Billions of Dollars		In Billions of Dollars	In Percents
National Defense	252	424	172	68
Entitlements and Other Mandatory Spending	436	577	141	32
Health care	(92)	(152)	(60)	(65)
Retirement & disability	(253)	(341)	(88)	(35)
Other a/	(91)	(84)	(-7)	(-8)
Nondefense Discretionary	168	211	44	26
Net Interest	130	230	100	77
Offsetting Receipts	-48	-65	-18	38
Budget Outlays	938	1,378	440	47
Off-Budget Outlays	11	6	-5	-44
Total Outlays	949	1,384	435	46
Reference: GNP	3,855	5,606	1,751	45
	As a Percent of GNP		Percent Change in GNP Share	
National Defense	6.5	7.6	15.8	
Entitlements and Other Mandatory Spending	11.3	10.3	-8.9	
Health care	(2.4)	(2.7)	(13.9)	
Retirement & disability	(6.6)	(6.1)	(-7.3)	
Other a/	(2.4)	(1.5)	(-36.9)	
Nondefense Discretionary	4.3	3.8	-13.6	
Net Interest	3.4	4.1	21.7	
Offsetting Receipts	-1.2	-1.2	-7.3	
Budget Outlays	24.3	24.6	1.0	
Off-Budget Outlays	0.3	0.1	-64.3	
Total Outlays	24.6	24.7	0.3	

a. The comparison of 1985 to 1990 in this line is distorted by a $13 billion one-time outlay in 1985 resulting from a change in the method of refinancing public housing. See CBO's *The Economic and Budget Outlook: Fiscal Years 1986-1990* (February 1985), p. 134.

BOX I-1.
FEDERAL BUDGET CATEGORIES a/

National Defense. Outlays for military and civilian personnel, operating costs, and major weapons procurement. Military and civilian workers' pay increases are included in the projections.

Entitlements and Other Mandatory Spending. Programs in which spending is governed by a law making all who meet their requirements eligible to receive payments. Subcategories are:

> **Health Care.** Includes outlays for Medicare and for the federal share of Medicaid expenditures.
>
> **Social Security and Other Retirement and Disability Programs.** Includes old-age, survivors, and disability benefits under Social Security, as well as other federally financed retirement and disability programs, including federal civil service and military retirement and disability programs, veterans' pensions and compensation, and Supplemental Security Income.
>
> **Other Entitlements.** Entitlements and other mandatory spending not included above. Major examples are: non-means-tested or partially means-tested benefits such as Unemployment Insurance, Guaranteed Student Loans, and child nutrition; means-tested benefits such as Food Stamps and Aid to Families with Dependent Children; certain state and local grants such as General Revenue Sharing and the Social Services Block Grant; and agricultural price supports.

Nondefense Discretionary Spending. All nondefense programs for which spending is determined by annual appropriations, or by loan or obligation limits imposed in appropriation acts. The basic governmental legislative, judicial, and tax-collecting functions are included. A large part of this category represents the salary and expense accounts that finance the ongoing operations of the civilian agencies of government. Most grants to state and local governments (other than for benefit payments) and nondefense research and development are also in this category.

Net Interest. Interest payments on the federal debt less interest received by trust funds and other interest.

Offsetting Receipts. Proprietary receipts from the public and the employer share of employee retirement. Other receipts (for example, foreign military sales, trust fund receipts, and payments to trust funds) appropriately netted against outlays are included in the relevant categories above.

---

a. For more detail, see tables and boxes in Chapter II.

Composition of Revenues

The projections show revenues remaining stable during the next five years, both in their composition and as a proportion of GNP (see Table I-2, below).

Receipts from the individual income and payroll taxes provide the bulk--81 percent in 1985, 83 percent in 1990--of federal revenues. The rise in income tax receipts as a share of GNP reflects the projected growth in real incomes.

Putting Spending and Revenue Together

Revenues plus offsetting receipts in 1990, under the CBO projection, will fall $79 billion short of covering outlays in just the defense, entitlements, and interest categories (see Figure I-1, page 8). Even if all other federal programs were eliminated, the deficit would be high by historical standards; for example, as a percentage of GNP, it would be twice the average of the 1960s.

THE USE OF FORMULAS

Because of the magnitude of the deficit problem, and the complexity of cutting it on a program-by-program basis, many have suggested using some simple rule or formula as a guide. One example is a budget freeze. There are many possible variants on this theme--indeed, there are many alternative definitions of a freeze (see Box I-2 on page 9).

TABLE I-2. COMPOSITION OF CBO BASELINE REVENUES
(In fiscal years 1985 and 1990)

	As a Percent of GNP		As a Percent of All Revenues	
Tax Type	1985	1990	1985	1990
Individual Income	8.6	9.2	45.3	47.3
Corporate Income	1.6	1.9	8.6	9.8
Payrolls	6.9	6.9	36.2	35.8
Excise	1.0	0.7	5.2	3.1
All Other	0.9	0.8	4.9	3.9
Total	19.1	19.4	100.0	100.0

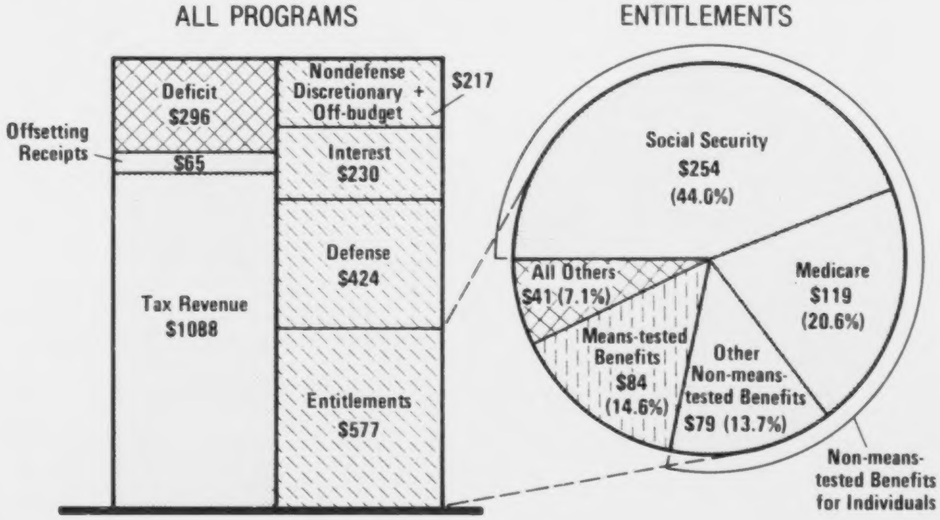
The Advantages of Following a Rule

Formula approaches have obvious advantages. They are simple compared to the alternative of beginning from the ground up with the thousands of individual programs that make up the federal budget. A formula spreads the burden broadly, instead of concentrating it on a relatively small group, and many believe this to be equitable. A formula would be easily enforceable in the sense that exceptions would become conspicuous.

Some formula approaches to deficit reduction tie together the spending and revenue sides of the budget. For example, one formula would limit cost-of-living adjustments in benefits to the change in the Consumer Price Index minus two percentage points, and apply a similar constraint on the revenue side to indexing the income tax. In this way, both beneficiaries and taxpayers would receive less than complete protection against inflation. The symmetry of such a formula would make it more difficult, though not impossible, to divert the added revenue to some purpose other than deficit reduction. In this sense, it would resemble the trust fund system for pro-

Figure I-1.

Composition of the Federal Budget in 1990 (In billions of dollars)



SOURCE: Congressional Budget Office.

BOX I-2.
WHAT DOES FREEZING THE BUDGET MEAN?

The term "budget freeze" has no single agreed definition. It can mean holding spending constant in dollar terms; in this usage, government would decline in size, because this year's dollar cannot purchase as much as last year's. It can also mean holding spending constant in real terms by adding enough to offset the effects of inflation, in which case nominal spending would be higher after the freeze than before it.

Another element of the definition is whether the freeze is placed on budget authority or on outlays. For the most part, the Congress does not control the timing of outlays. The Executive Branch decides when a contract is let, when a check is delivered, or when a loan is made. The Congress decides the level of budget authority and can freeze that level, but outlays may rise because of timing quirks in actual spending decisions. If a budget authority freeze continues long enough, of course, outlays will ultimately level out as well.

However one defines "budget freeze," there must always be exceptions to the freeze, interest on the debt being the most obvious one. Contract commitments must be honored as well. Unemployment insurance tax and benefit levels are set by the states, not by the Congress, so that even though the receipts and outlays for the state programs are technically recorded in the federal budget, their levels cannot well be frozen by a Congressional decision.

Entitlement programs in general are difficult to freeze. Unless eligibility rules are changed, Social Security spending must rise as more people reach retirement age and live longer. Medicare and federal civilian and military retirement programs present the same barrier to a freeze as does Social Security. Consequently, a budget freeze for such entitlements usually can only mean a limitation on annual cost-of-living adjustments (COLAs) in those programs. Such a limitation can take many forms, such as skipping the COLA for one or more years, or delaying the adjustment date by six months, or allowing only a partial adjustment.

grams like Social Security, Medicare, and highways, where outlay levels are linked to earmarked revenue levels.

The Difficulties with Rules

A serious drawback in using arbitrary freeze-type rules for budgeting is that some very good and efficient programs may be cut too much, while some inefficient programs will not be dealt with severely enough. This imbalance might be diminished by applying the rule only to broad categories of programs, while allowing considerable flexibility for more narrowly defined program groupings within the wider categories.

Another approach would be to define the categories very narrowly, but to entertain appeals for exceptions. The function of the arbitrary rule in this instance would be to eliminate any presumption that a program should be continued as usual. It would shift the burden of proof to those who advocate spending above whatever constraint is provided by the rule. If the rule was not sufficiently stringent, some low-priority programs might not be cut enough, while an overly stringent rule might provoke such a flood of legitimate appeals that the rule would be left in tatters.

Rules that appear evenhanded at first sight often turn out to be anything but that. For example, freezing the spending of all agencies at last year's levels may appear to treat everyone equally. But if last year an agency was instructed by law to make contracts resulting in huge outlays beginning this year, it might have to slash many of its other programs drastically--irrespective of their merits--in order to honor the contracts. In contrast, an agency with a relatively stable spending level would have much more flexibility.

Again, while exceptions can be made to deal with special cases, part of the appeal of arbitrary budget rules is their apparent simplicity; as exceptions multiply and the rules become more complicated, their desirability rapidly diminishes. Arbitrary rules are best thought of as temporary expedients, since their inefficiency grows with time. As a strategy in deficit reduction, they offer the chance to make substantial progress in lowering the deficit while more substantive and fundamental changes in spending and taxing policies are being examined.

Illustrative Application of Formulas

Even the simplest formulas can produce strikingly different results depending on their detailed application. Assume, for example, that the 1988 deficit target is 2 percent of GNP, to be achieved without a tax increase, but solely by some uniform distribution of cuts across three major outlay categories: defense, entitlements and other mandatory spending, and nondefense discretionary spending. (Interest payments can only be changed by altering deficits and the resulting stock of debt.) A formula path to the target could be shaped either as an equal percentage reduction from 1986-1988 baseline spending, or as a uniform rate of growth from 1985 spending levels. Table I-3 shows how the two options differ. In Option 1, the baseline figure for each major category is reduced annually by the same percentage--3.0 percent in 1986, 8.4 percent in 1987, and 13.3 percent in 1988. Option 2 allows each category to grow from 1985 by the same rate--an average of 1.8 percent a year (instead of the 7.9 percent average rate in the baseline).

The dramatic differences between the two options result simply from the changing composition of baseline spending identified in Table I-1. The CBO baseline projects 1988 defense spending 38 percent above the 1985 level, entitlements up 17 percent, and nondefense discretionary outlays only 14 percent over 1985. Therefore, the equal growth rate formula (Option 2) must necessarily fall most heavily on the defense category. Option 1, on the other hand, while still calling for lower defense spending than in the baseline, nevertheless allows that category to grow more rapidly than the others.

TABLE I-3. ALTERNATIVE PROGRAM REDUCTIONS NEEDED TO REACH 1988 DEFICIT TARGET EQUAL TO 2 PERCENT OF GNP (In billions of dollars)

	1986	1987	1988
Option 1: Equal Percentage Reductions			
National Defense	8	26	48
Entitlements a/	12	36	61
Nondefense Discretionary b/	5	15	25
Total Reductions	25	78	132
Option 2: Equal Growth Rates			
National Defense	26	52	81
Entitlements a/	-4	17	37
Nondefense Discretionary b/	3	9	14
Total Reductions	25	78	132

SOURCE: Congressional Budget Office.

a. Includes other mandatory spending and offsetting receipts.

b. Includes off-budget spending.

Yet another picture would emerge if the base year chosen were 1984 rather than 1985. In short, the operative effects of formulas that resemble one another may vary widely.

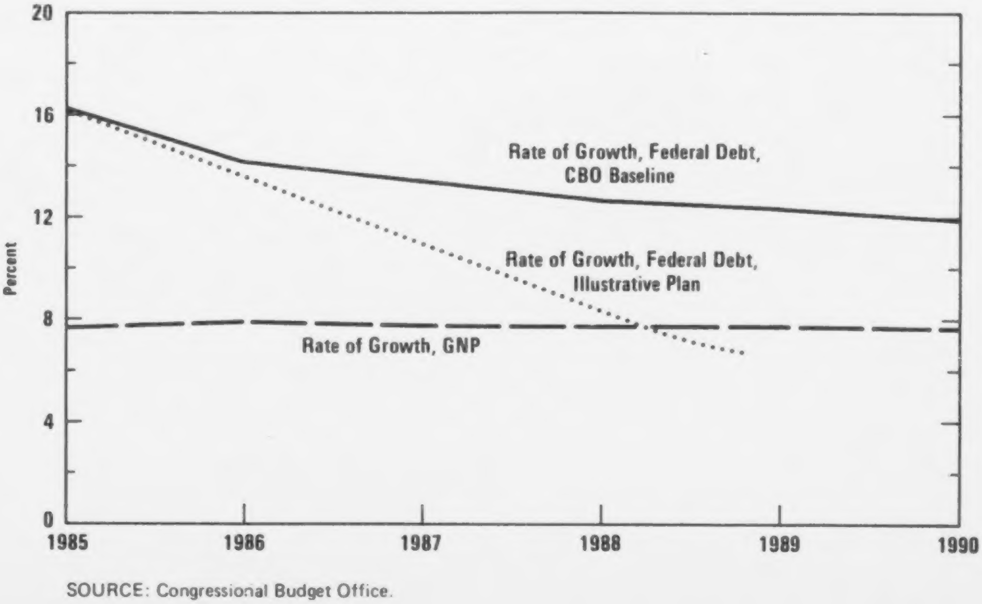
THE DIMENSIONS OF THE TASK

Under CBO's projections, GNP will rise by 45 percent between 1985 and 1990. But during the same period projected deficits are so large that the federal debt held by the public will grow by 83 percent. Because the debt is rising much more rapidly than GNP, the debt-to-GNP ratio must rise as well, from 39.6 percent in 1985 steadily up to 49.7 percent in 1990.

In theory, at least, the debt-to-GNP ratio would eventually stabilize, even under current policies, but only after many years and further huge increases in interest payments as a proportion of all federal spending. The sooner the growth rate of the debt can be brought down to that of GNP, the sooner the interest share will stop climbing.

Figure I-2 shows the 1985-1990 growth rates for both debt and GNP. The dotted line is an illustration of a deficit-reduction program that would by 1988 bring a halt to the rise in the debt-to-GNP ratio, with a likely prospect that later years would see an actual decline in the ratio.

Figure I-2.



SOURCE: Congressional Budget Office.

The dollar implications of the illustrative deficit-reduction plan for 1988 are spelled out in Table I-4. Spending programs would have to be cut by $90 billion below the baseline in that year or taxes raised by a like amount, or some combination. By way of comparison, $90 billion is about twice the third-year deficit-reduction value of the "down payment" enacted in 1984.

The year 1988 was chosen as the target year in this illustration because it coincides with the planning horizon of the Congressional budget resolution to be voted this year. Whether, by when, and by how much the deficit will be brought down are political decisions for the Congress and the President to make.

In any event, the costs of delay are very high. If nothing is done this year, but the illustrative plan is adopted with the 1987 budget instead, the interest savings in 1988 would fall from the $14 billion shown in Table I-4 to $6 billion, meaning that in order to reach the target deficit, $8 billion more in program reductions or tax increases would have to be found, an amount equivalent to more than three times the entire budget of the Department of Commerce. On the other hand, acceleration of the illustrative plan would provide a greater margin of safety in the event that the CBO economic assumptions turn out to be too optimistic.

TABLE I-4. DEFICIT REDUCTION UNDER ILLUSTRATIVE PLAN (Fiscal year 1988, in billions of dollars)

CBO Baseline, Total Deficit	249
Illustrative Plan, Total Deficit a/	-145
Deficit Reduction Needed	104
Interest savings	-14
Program reduction/tax increase	90
Memo:	
Debt held by public, CBO baseline, end of year	2,220
Illustrative plan, end of year	2,023

SOURCE: Congressional Budget Office.

a. Illustrative plan assumes a phased-in program reduction/tax increase beginning with program reductions/tax increases of $30 billion in 1986 and $55 billion in 1987, approximately the same savings pattern for those years as that contained in the Congressional Budget Resolution for 1985. Many other patterns could also be consistent with the same 1988 target.

USES OF THIS VOLUME

The next chapter discusses broad issues involving six program groupings: defense, entitlements, agriculture, the federal civilian work force, nondefense discretionary programs, and revenues. The discussion is followed by 88 specific spending-reduction options (beginning on page 63), and by 35 specific revenue-raising options (beginning on page 225).

The reader should keep several cautions in mind. The separate options cannot be added to a grand total. A number of them are mutually exclusive, so that summing them would produce a meaningless figure. The savings effects of each are calculated separately, as if none of the other options were to become law, but in fact there would be interactions among the options if many of them were enacted. As a result, the consequences of enacting a package would be different from enacting each of its components in isolation.

The deficit reductions discussed in this volume represent only a first approximation of savings that might actually be realized. Variations on any particular option can, of course, be used to vary the savings it is likely to achieve. In some instances, a reduction in one program might result in program expansion elsewhere. Narrowing eligibility for VA hospital care, for example, would lead to some increase in Medicare outlays. In most cases, unless otherwise specified, such offsetting effects are not included in the estimates presented in this report.

Any enduring reduction in outlays or increase in revenues will ultimately result in a lower public debt, and therefore in lower net interest outlays than would otherwise be the case. Thus, a one dollar cut in a spending program or a one dollar tax increase lasting for the 1985-1990 period implies--at CBO's projected interest rate--an interest saving during 1990 of more than 70 cents. While one could calculate such savings for any specific deficit-reduction measure, the number would not be particularly useful for it would depend entirely on how many years of cumulative deficit reductions were assumed. The useful number is the net impact on interest outlays stemming from the whole budget enacted by the Congress. Hence, the estimates for specific options do not include induced interest savings.

In general, the estimated savings or revenue gains calculated for the deficit-reduction options in this volume are derived from the economic assumptions underlying the CBO baseline. Reestimates would be necessary in most cases if different economic assumptions were used. The CBO estimates are static in that they do not take account of the impact of particular options on the economic behavior of those people affected.

CHAPTER II

BROAD ISSUES IN DEFICIT REDUCTION

This chapter presents the principal issues for the Congressional choicemaker. It presupposes that targets have been set for overall deficit reduction, and examines the main choices to be made in each major spending sector and in the revision of taxes.

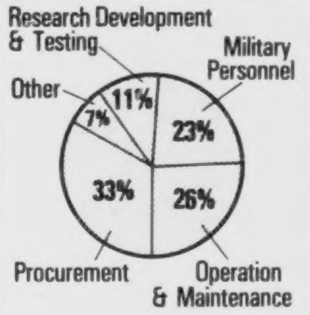
While it would be helpful to discuss major tradeoffs between categories (for example, the relative impacts of $10 billion less in national defense as against $10 billion less in Social Security benefits), such considerations very much depend on values and political orientation and are better left to the country's elected representatives.

Each section of the chapter is devoted to a major spending sector, and provides a brief recent history of spending and notes the major sources of spending growth.

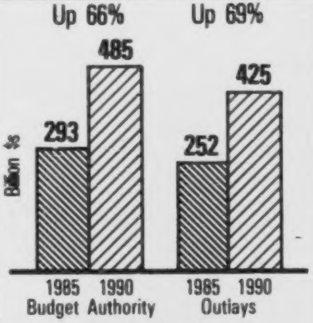
In addition to discussing national defense, entitlements, and nondefense discretionary spending, the chapter gives special attention to agricultural price supports (a subcategory of entitlements) and to federal personnel, construction, and management issues (affecting all spending categories). Such attention appears warranted because agricultural price supports are due for reauthorizing legislation in 1985, and because management improvements should rank high on anyone's list of preferred options. Revenues are discussed in the last part of the chapter.

Section II of the volume provides a listing of specific choices for spending reductions or tax increases. These specific options are grouped by budget function and summarized in a table at the end of Section II.

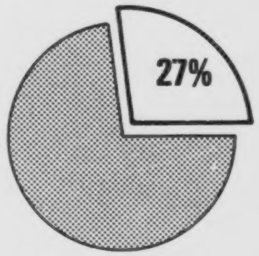
NATIONAL DEFENSE



Composition of 1985 Budget Authority



Budget Authority and Outlays, CBO Baseline 1985-90



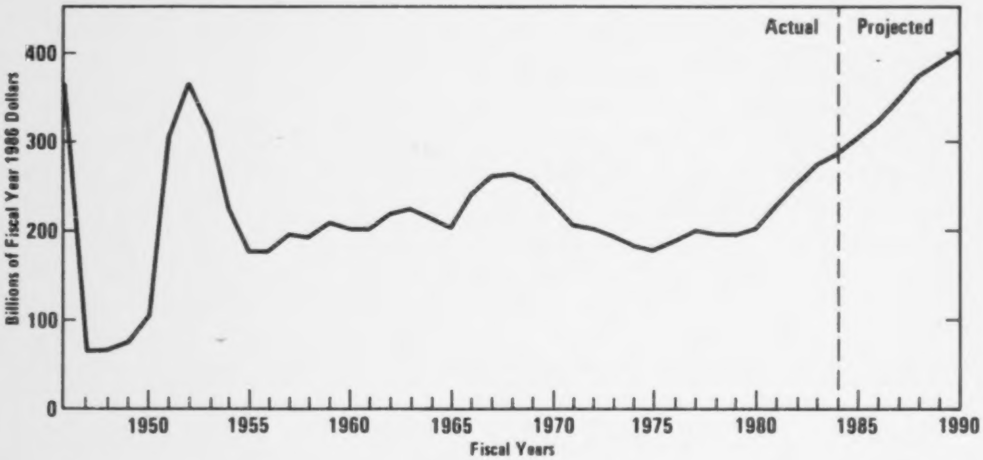
1985 Share of Budget Outlays

The national defense portion of the federal budget supports two major activities: procuring, operating, and maintaining the equipment of the armed forces, and recruiting, training, and paying manpower. In 1985 about 53 percent of the budget authority in the national defense function will be spent for personnel and operating and supporting the forces. The remaining 47 percent, referred to as the "investment accounts," will fund the procurement, research and development, and military construction associated with the armed forces. National defense spending is devoted to several military purposes (so-called "missions"), with general purpose forces receiving the largest share. Although spending for strategic nuclear forces often generates substantial debate, it accounts for only 10 percent of the total defense budget for 1985, according to Administration estimates.

Today, budget authority for national defense stands at the highest level of any peacetime period in the history of the United States, even after adjusting for inflation (see Figure II-1). This reflects six consecutive years of real, or inflation-adjusted, increases in defense budget authority, a period of sustained real growth unprecedented in the recent past. Defense spending has also increased as a percentage of gross national product (see Figure II-2). This measure of the defense budget is perhaps the most comprehensive way to assess the resources the United States devotes to its security. Defense outlays grew from roughly 5.0 percent of GNP in 1979 to 6.3 percent in 1984, but their share remained well below earlier peacetime periods.

Figure II-1.

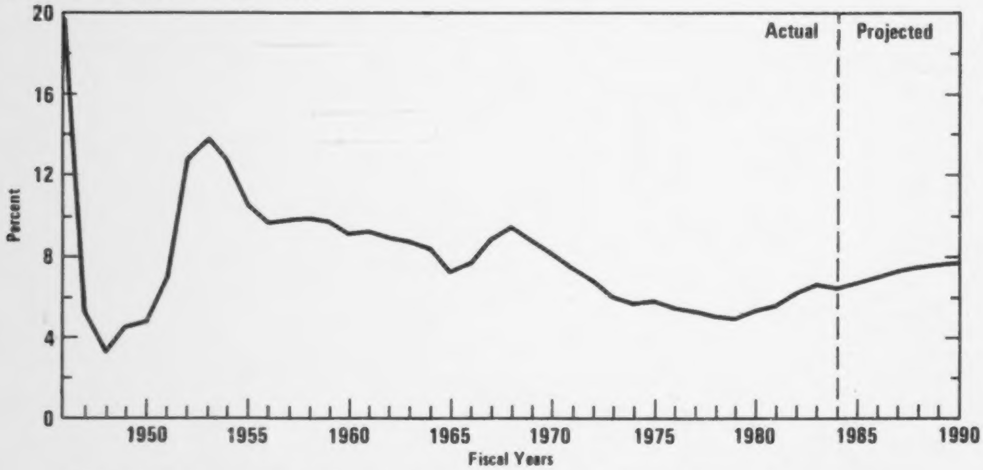
National Defense Budget Authority, Fiscal Years 1946-1990 (In Constant 1986 Dollars)



SOURCE: CBO calculations based on data from the Department of Defense.

Figure II-2.

National Defense Outlays as a Percent of GNP, Fiscal Years 1946-1990



SOURCES: CBO from: historical data, Department of Defense; projections, *Budget of the United States Government, Fiscal Year 1985.*

Growth in Procurement

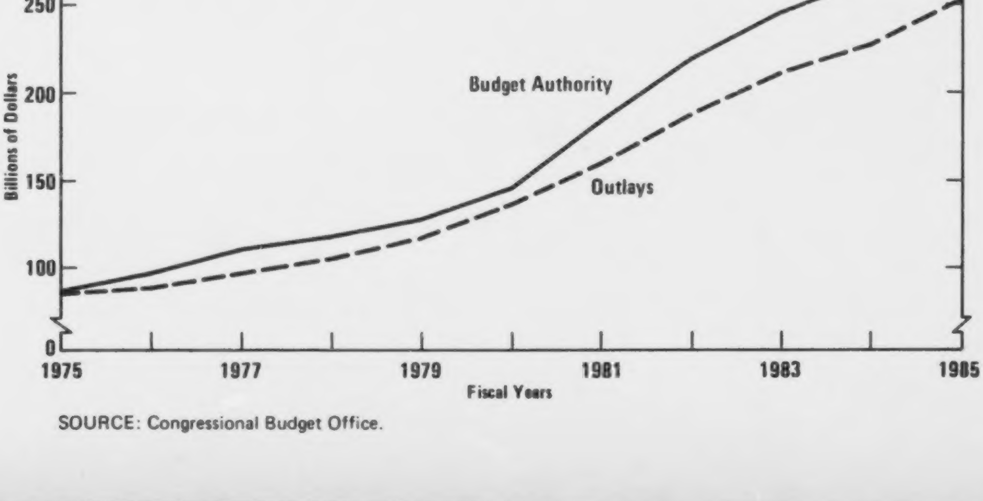
The recent rise in defense spending clearly has been slanted toward the investment accounts. Since 1980 real budget authority for procurement, research and development, and military construction has increased by $65 billion, or 93 percent. The operating accounts (operation and maintenance and pay) have increased by $28 billion, or 24 percent. In 1985 investment will account for 47 percent of the Department of Defense (DoD) budget, compared with 36 percent in 1980.

The emphasis on investment constrains any attempts to reduce defense outlays quickly. The Congress appropriates budget authority, which represents the right to enter into contracts for defense goods and services. Actual spending, or outlays, can take place over a number of years, depending on the nature of specific contracts. The lag of outlays behind Congressional authorizations is particularly long for weapons procurement. For example, of each dollar of budget authority provided each year in the procurement accounts, only 13 cents, on average, contributes to the outlays for that year. On the other hand, about 80 cents of each dollar authorized in the operation and maintenance accounts in a given year contributes to that year's outlays. It is outlays that are calculated in the budget deficit, not budget authority.

The recent emphasis on investment has caused budget authority to exceed outlays by large amounts (see Figure II-3): Thus, even if the Con-

Figure II-3.

National Defense Budget Authority and Outlays, Fiscal Years 1975-1985



SOURCE: Congressional Budget Office.

gress curtailed growth in budget authority, outlays would continue to increase for several years. In order to reduce defense outlays significantly in 1987, 1988, and beyond--while continuing to maintain the current operating tempo--budget authority for investment accounts would have to be reduced in 1986. Of 1986 budget authority for the procurement accounts, about 33 percent will be spent in 1987 and about 25 percent in 1988.

The Administration 1986 Defense Request

The Administration proposes to continue increases in defense spending. The latest DoD five-year plan requests \$322.2 billion in budget authority and \$285.7 billion in outlays for 1986; by 1990 budget authority rises to \$488.1 billion and outlays to \$428.6 billion (see Table II-1). For budget authority, this represents real growth of 5.2 percent over fiscal year 1985 and an average real growth of 5.6 percent a year from 1986 through 1990, assuming CBO baseline economic assumptions. The Administration proposals fall below the CBO baseline by \$2.5 billion in budget authority in 1986 but exceed the baseline by \$26.9 billion over the 1986-1990 period. (See footnote a/ in Table II-1 for an explanation of the CBO baseline for defense.) Outlays are above the baseline by \$3.8 billion in fiscal year 1986 and by \$35.5 billion over the five years.

Although the Administration request is within the limits of the budget authority for fiscal year 1986, as specified in the 1985 budget resolution, it might not be consistent with deficit reduction targets, especially for future years. For example, over the 1986-1990 period, zero real growth would require a reduction of \$345.1 billion below the Administration request and \$318.3 billion below the CBO baseline.

Strategies for Achieving Alternative Rate of Real Growth

The defense debate will probably take place on several levels. First, what should the total level of defense spending be? Second, how much should be allocated to specific programs, such as the MX missile and military retirement? Third, what other kinds of detailed guidance should be given to determine DoD policies?

Because of the complexity of the defense budget, it would be extremely difficult for the Congress to reexamine each of the individual judgments made by the Administration. The Congress might wish, however, to consider some alternative strategies for reducing the defense budget and to examine selected options within each strategy. The following discussion describes

TABLE II-1. ALTERNATIVE LEVELS OF DEFENSE SPENDING
(By fiscal year, in billions of dollars)

	Actual		Estimated	Projections				
Levels	1980	1983	1985	1986	1987	1988	1989	1990
CBO Baseline--1985 Budget Resolution Extended a/								
Budget Authority	146	245	292.6	324.7	359.8	397.8	439.4	485.4
Outlays	136	211	252.0	281.9	313.2	347.0	384.1	424.5
CBO Baseline--Zero Real Growth b/								
Budget Authority	146	245	292.6	306.2	320.8	336.7	353.6	371.4
Outlays	136	211	252.0	275.9	294.1	310.4	327.1	343.9
Administration Request c/								
Budget Authority	146	245	292.6	322.2	363.3	411.5	448.9	488.1
Outlays	136	211	253.8	285.7	321.2	358.4	392.3	428.6

SOURCE: Administration request from Office of Management and Budget, January 30, 1985.

a. The CBO baseline is an extension of the 1985 Congressional budget resolution. The budget authority figures for 1986 and 1987 were specified in the budget resolution. Beyond 1987, the CBO baseline expands real defense budget authority by 5 percent a year, consistent with the economic assumptions in the 1985 resolution. Outlays have been reestimated to be consistent with currently estimated spending patterns.

b. CBO computes a baseline with no real growth by adjusting actual 1985 appropriations at the account level for inflation only. The resulting path of budget authority and historical spending patterns are the basis for the associated outlay estimates. The difference between the no real growth projection and the budget resolution represents real growth. (See CBO, *The Economic and Budget Outlook: Fiscal Years 1986-1990*, Table II-3, p. 57.)

c. Outlays are Administration estimates.

five such strategies and refers to some specific examples that illustrate each one. (Because the Defense Department employs large numbers of civilian workers, its budget could also be reduced by measures affecting the size and compensation of the government's work force. See section on Federal Personnel, Management, and Construction.)

Reduce Rates of Growth in Major Procurement. The Congress could choose to limit real growth in the major procurement accounts that pay for large weapons. Such an approach would preserve the current force size and its ability to operate at high peacetime rates, but it would delay modernization. Reductions could be achieved by cancelling selected weapons programs of lower priority, by limiting the rate of production of ongoing weapons programs, or by redirecting modernization along alternative and cheaper lines (see DEF-01 through DEF-11 in Section II).

Each approach poses different problems. Limiting the rate of production of ongoing weapons programs usually increases unit costs. Cancelling major weapons reverses previous Congressional decisions and might cause economic dislocations. While selecting cheaper modernization alternatives saves money, the process sometimes is difficult and contentious since cheaper weapons do not always satisfy DoD desired specifications.

Because of the many major procurement programs in the current defense budget, reducing growth in these accounts would produce large near-term savings in budget authority. Outlay savings would be smaller in the near term but would eventually grow.

Limit Increases in Other Investment. Other investment accounts include research and development, military construction, and supporting procurement (this last category pays for smaller weapons and support vehicles like trucks and fuel carriers). Among other effects, slowing growth in these accounts would probably delay improvements in the ability of military forces to sustain combat over a protracted period. This approach, therefore, would be most consistent with planning for a shorter, more intense conflict, rather than for protracted fighting. The effects of changes to these accounts are difficult to specify because of their diversity. Although the Congress sometimes has designated the accounts in which reductions were to be made, it has, as frequently, imposed undistributed reductions, allowing the military services to allocate the reduced funding among the vast number of activities and purchases that constitute this category. Options DEF-12 through DEF-15 in Section II illustrate the level of savings that could be achieved by a decision to moderate the growth of spending in these areas. These alternatives would produce more significant near-term outlay reductions than those described for the major procurement accounts.

Impose Limits on Future Growth in Forces. Administration plans call for increases in current military forces, especially for the Navy and Air Force. The Congress could choose to delay some of these increases, which would create a smaller force in the near term, but one with more capable weapon systems. Although such a force might be less able to handle numerous contingencies simultaneously, it could still provide a potent defense against the Soviet Union. This approach would provide relatively small savings (see DEF-16 and DEF-17).

Limit Further Improvements in Readiness. According to the military services, recent improvements have created a high level of readiness in the current forces. The Congress, therefore, could choose to limit further improvements in readiness by slowing growth in associated funds. Moreover, when readiness is high, even large increases in spending might produce only marginal increases in many readiness measures, such as flying hours, training days, and so-called "mission-capable" rates. Option DEF-18 describes this strategy, which offers substantial near-term savings in both budget authority and outlays.

Limit Growth in Pay and Benefits. Some 40 percent of DoD budget authority consists of pay and benefits to attract and retain adequate numbers of military and civilian employees. Adjustment to these categories could yield large, near-term savings in budget authority and outlays. One approach to limiting spending for these purposes is to reduce across-the-board pay increases and to limit additional compensation to those service skills that now have manpower shortages. Because recruiting and retention generally are well above levels typical in the 1970s, any adverse effects resulting from this option might be tolerable. Another approach would cut retirement and health-care costs by implementing changes that, according to many studies, would make the military compensation system more efficient (see DEF-19 through DEF-23).

Measuring the Effects of Alternative Rates of Real Growth

Although all the above strategies would save money, they probably would involve some increase in risk to national security by slowing the growth of military capability. Unfortunately, because vast uncertainties surround the nature of potential conflicts, this risk is extremely difficult to assess.

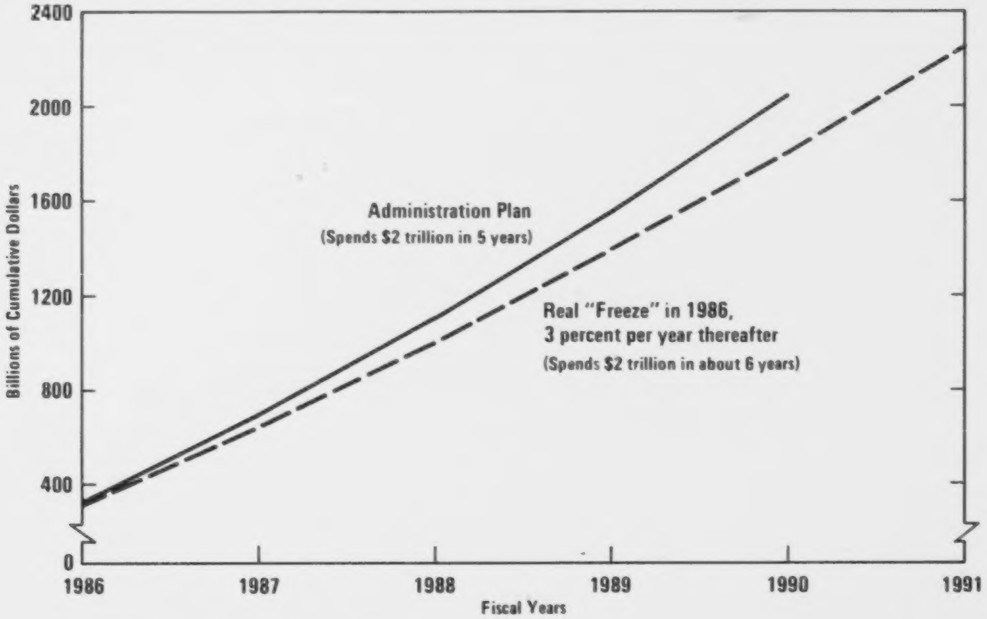
In the absence of an exact measure of security risk, the effects of a slower funding option can be partially determined by assessing the extra years required to achieve the Administration five-year plan in budget authority. For example, the Congress could consider an alternative to the

Administration program that would allow no real growth in defense budget authority in 1986, followed by 3 percent real growth in each of the succeeding years (see Table II-2). Under this approach, the cumulative budget authority proposed by the Administration from 1986 through 1990, $2,034 billion, would be spent over six years, 1986 through 1991 (see Figure II-4). In this option, the total amount of equipment purchased and research accomplished--items paid for out of the investment accounts--would be about the same after six years as they would after five years under the Administration plan. (Because of the funding required to maintain current operations, more than one additional year might be required under this alternative to achieve personnel or operations levels comparable to those resulting from the Administration five-year plan.)

This one-year delay is, however, only a partial guide to assessing the risk of a funding slowdown because of additional ongoing effects. In the absence of a delay, the Administration would have continued to procure additional weapons and accomplish research after the end of the five-year

Figure II-4.

Cumulative Budget Authority for National Defense: Administration Plan and Limited Growth, Fiscal Years 1986-1991



SOURCE: Congressional Budget Office.

TABLE II-2. BUDGET AUTHORITY UNDER ALTERNATIVE SPENDING ASSUMPTIONS (By fiscal year, in billions of dollars) a/

Spending Assumptions	1986	1987	1988	1989	1990	Cumulative Five-Year Total b/
			Budget Authority Level			
Administration Proposal	322.2	363.3	411.5	448.9	488.1	2,034.0
CBO Baseline	324.7	359.8	397.8	439.4	485.4	2,007.1
3 Percent Real Growth, 1986-1990	315.5	340.2	368.0	398.0	430.4	1,852.1
Zero Real Growth in 1986, 3 Percent in 1987-1990	306.2	330.4	357.2	386.4	418.0	1,798.2
Zero Real Growth, 1986-1990	306.2	320.8	336.7	353.6	371.4	1,688.7
			Budget Authority Savings from Administration Proposal			
3 Percent Real Growth, 1986-1990	6.7	23.0	43.5	50.9	57.7	181.8
Zero Real Growth in 1986, 3 Percent in 1987-1990	16.0	32.9	54.3	62.5	70.1	235.7
Zero Real Growth, 1986-1990	16.0	42.5	74.7	95.2	116.7	345.1
			Budget Authority Savings from CBO Baseline			
3 Percent Real Growth, 1986-1990	9.2	19.6	29.8	41.4	55.0	155.0
Zero Real Growth in 1986, 3 Percent in 1987-1990	18.5	29.4	40.6	53.0	67.4	208.9
Zero Real Growth, 1986-1990	18.5	39.0	61.1	85.8	114.0	318.3

SOURCE: Congressional Budget Office.

a. The CBO baseline and alternative growth rate assumptions are all based on CBO baseline economic assumptions. Outlay savings associated with each of the spending assumptions depend on the composition of specific options chosen. Outlays associated with the Administration's defense budget will be reestimated using CBO economic assumptions in CBO's analysis of the President's budget, February 1985.

b. Numbers may not add to totals because of rounding.

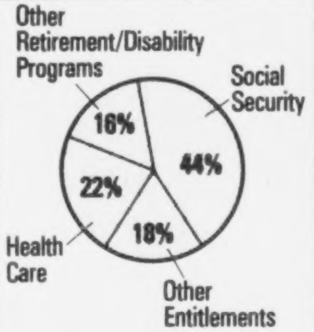
planning period. Thus, at the end of six years under this option, U.S. military capability would still be lower than it would be under the Administration plan. The loss in relative capability could be offset by higher spending in the 1990s, when the deficit might be lower, or the loss could be accepted.

Specific Options

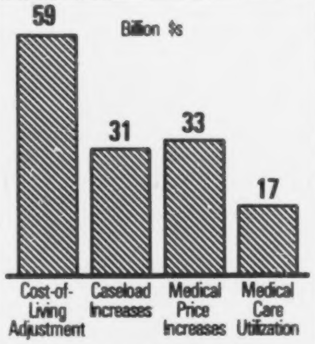
Section II of this volume contains 23 specific options that could reduce defense spending. Each illustrates one of the strategies noted above. In contrast to other budget functions in this report, savings for these options are measured relative to the Administration's latest budget proposal since that proposal provides the program detail necessary to assess defense savings.

The 23 defense options in Section II are only illustrative. The Congress might, for example, decide that it wished to reduce defense spending substantially more than could be achieved with these options. Deeper cuts could require reductions in the number of U.S. forces below today's levels or could mandate early cancellation of a number of lower-priority weapons programs. Substantially lower spending levels might also force the Department of Defense to take further steps to minimize duplication of effort and wasteful management practices. Finally, if spending were reduced far enough, it might be necessary to restructure both major procurement objectives and the size and nature of the military forces. Such cuts might imply reductions in U.S. foreign policy commitments. While certainly affecting defense capabilities, these further actions could eliminate the need for growth in the defense budget in the next few years and eventually result in substantial reductions in the federal deficit.

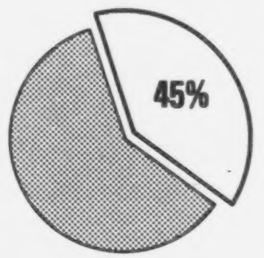
ENTITLEMENTS AND OTHER MANDATORY SPENDING



Composition of 1985 Outlays



Major Sources of Outlay Growth 1985-90



1985 Share of Budget Outlays

Entitlements and other mandatory spending constitute the largest single component of the federal budget. Entitlement programs are those that provide benefits to any person, business, or unit of government that meets eligibility requirements established in law or regulations. Under these programs, federal outlays depend on the number of eligible people or organizations that apply for aid and the amounts for which they qualify. During the past several years, other permanent appropriations and certain annually appropriated programs--including some grants to state and local governments--have been treated as mandatory spending items for the purpose of developing Congressional budget resolutions. Outlays under all of these programs--referred to hereafter merely as entitlements--are expected to total $420 billion in 1985, or 45 percent of unified budget outlays. If current policies are continued, entitlement spending will rise to $565 billion by 1990 (see Table II-3). (These totals exclude outlays for agricultural price-support programs, which are entitlements; these programs are discussed in the following section.)

In this volume, entitlements--other than agricultural price supports--are divided into three groups of programs:

- Health care, composed of the Medicare and Medicaid programs;
- Social Security and other retirement and disability programs; and
- Other entitlements, including benefits to individuals and selected grants to states or localities.

TABLE II-3. BASELINE PROJECTIONS OF OUTLAYS FOR ENTITLEMENT PROGRAMS OTHER THAN AGRICULTURAL PRICE SUPPORTS (In billions of dollars)

	1984	1985	Projections				
	Actual	Base	1986	1987	1988	1989	1990
Health Care							
Medicare	61	69	76	85	95	107	119
Medicaid	20	22	24	26	28	31	33
Subtotal	82	92	100	111	124	137	152
Social Security and Other Retirement Disability Programs							
Social Security	174	185	196	209	224	238	254
Federal Civilian Retirement and Disability	22	23	25	26	28	30	32
Military Retirement and Disability	16	16	18	19	20	21	23
Veterans' Pensions and Compensation	14	14	14	15	15	15	16
SSI	8	10	10	10	12	11	11
Other	5	5	6	6	6	6	6
Subtotal	240	253	268	286	305	322	341
Other Entitlements							
Non-means-tested and Partially Means-tested Benefits							
Unemployment Insurance	18	17	17	17	17	18	18
Guaranteed Student Loans	3	3	3	3	3	4	4
Child Nutrition	4	4	4	4	5	5	5
Means-tested Benefits							
Food Stamps	12	12	12	12	13	14	14
Assistance Payments	8	8	9	9	9	9	10
Other	3	2	3	3	3	3	3
Grants to States and Localities & Other							
General Revenue Sharing	5	5	5	5	5	5	5
Social Services	4	4	4	4	4	4	4
Other	10	19	8	8	8	8	7
Subtotal	67	75	65	66	68	69	71
Total	388	420	433	463	497	529	565

Together, these programs constitute a social insurance and welfare system that helps pay for the health care of about 50 million people; provides cash payments to more than 37 million retirees and disability annuitants (the great majority of whom also qualify for health care assistance); and combinations of cash and in-kind income to millions of additional people through such diverse programs as Unemployment Insurance (UI), Food Stamps, and subsidized loans for postsecondary students.

Outlays under most entitlement programs grew sharply in the 1970s. This growth was fueled primarily by rapid rises in health care costs and by the indexing of retirement and disability benefits during a period of high inflation. By contrast, welfare payments less often kept pace with rises in the cost of living. Since 1980, lower inflation and changes in law restricting eligibility and constraining benefits have combined to slow spending growth, particularly in the health care programs.

Despite policy changes enacted to date, opportunities for further savings are available. 1/ By necessity, however, virtually all savings options would either disqualify some people for aid or reduce benefits for those who continue to qualify. Thus, decisions regarding specific spending cuts in this area should be viewed in the context of a larger issue--namely, what are the appropriate dimensions of the federal social insurance and welfare system?

Health Care Programs

The Medicare and Medicaid programs help finance health care for about one-fifth of the U.S. population at an estimated total cost to the federal government of $92 billion in 1985. Medicare pays the bulk of all costs for hospital care for elderly people and Social Security disability annuitants, with benefits financed through a payroll tax on workers. In addition, participants may receive coverage for a large share of their nonhospital health care costs--principally physicians' charges--by enrolling in a Supplementary Medical Insurance (SMI) program and paying a premium that currently covers about 25 percent of total program costs. Under the Medicaid program, the federal government shares with states the cost of financing health care for recipients of Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI), and for other low-income people whom states may deem to be medically needy.

Recent legislative changes have restrained growth in both Medicare and Medicaid outlays. Beginning in 1982, limits on the rates at which

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1. The term "savings" refers to lower federal spending or higher revenues than would occur if current policies were continued. Under most of the options described in this section, federal spending would continue to rise in the future, but at a slower rate than now projected.

hospitals are reimbursed for the care of Medicare patients were broadened, and in 1984, a 15-month freeze was imposed on reimbursement rates for physicians. Other recent actions have increased beneficiaries' costs by raising deductible and premium amounts under the program's optional physician coverage.

Between 1981 and 1983, legislative actions on Medicaid lowered temporarily federal matching grants for many states and gave states greater flexibility in determining hospital reimbursement policies and in establishing alternative services to institutional care. Also, legislation enacted in 1981 restricted eligibility for the AFDC program, which, in turn, cut eligibility for Medicaid. The savings from these policy changes will be partially offset by decisions in 1984 that extended Medicaid eligibility to all low-income pregnant women and phased in eligibility for all children under five years of age from families with incomes below states' AFDC needs standards.

Spending constraints, as well as the play of other forces in the health care system, have slowed Medicare and Medicaid outlay growth appreciably in recent years. Spending, however, is still rising more rapidly than overall outlays. If current policies are continued, federal spending for these programs is expected to rise more than 65 percent by the end of the decade, growing from 10 percent to 11 percent of the federal budget. In addition to contributing to the deficit, rising Medicare outlays threaten the solvency of the Hospital Insurance (HI) Trust Fund by some time in the 1990s.

Two approaches are available to slow the growth in future spending for health care programs: change the programs themselves; or slow the rate of increase in overall costs of private and publicly supported health care, thus indirectly reducing the amount paid by the federal government.

Making Program Changes. The growth in Medicare outlays could be further slowed by making a number of changes in the programs. First, reimbursement rates for hospitals and physicians could be constrained more. This approach is intended to limit income for health care providers, rather than to raise costs for beneficiaries. Any further limitation on reimbursements, however, could reduce access or the quality of care for Medicare patients. ENT-02 to ENT-04 in Section II discuss specific options for limiting reimbursements.

A second approach would be to require Medicare beneficiaries to pay a larger share of their health care costs by, for example, increasing deductible amounts or copayment rates (see ENT-08 to ENT-10). Such an approach might discourage unnecessary use of health services, but it would also impose the burden on those who make most use of the Medicare system--namely, the very ill.

Finally, revenues earmarked to pay for Medicare could be increased. Specific examples include increasing the current HI payroll tax, raising the SMI premium, or raising excise taxes on tobacco and alcohol products--the consumption of which increases future health care costs--and earmarking the revenues for the Medicare program (see ENT-05 to ENT-07, ENT-11, and REV-07).

Under the Medicaid program, further savings could be realized by restricting either eligibility or reimbursements for certain services. One example of this last approach would be to limit payments to states for services for long-term care. This option is discussed in ENT-12 in Section II.

Slowing Growth in Health Care Expenses. Increases in overall health care costs can be curtailed in two ways. One approach is to reduce the demand for health care by increasing the share of medical expenses that individuals are required to pay themselves. For example, if the federal government taxed as income some share of health insurance premiums now paid by private employers, people might become more cost-conscious in the coverage they choose and in the choices they make as consumers of medical care. At the same time, federal revenues would increase immediately. This option is discussed in greater detail in ENT-01 of Section II.

Alternatively, growth in health care expenses could be curtailed through regulation. For example, the federal government could encourage states to establish systems that limit the amount by which all parties reimburse hospitals for services they provide. Extending hospital reimbursement limits to all payers would entail a major change in the nation's health care system, however, and the full effects are difficult to forecast.

Social Security and Other Retirement and Disability Programs

Social Security and other retirement and disability programs make up the largest component of the entitlements portion of the budget. In addition to Social Security, this spending category includes civil service and military retirement programs; a federally administered retirement program for former railroad employees; veterans' compensation and pension benefits; Supplemental Security Income for low-income aged, blind, and disabled people; and several smaller programs. Together, these programs are expected to cost the federal government $253 billion in 1985. Social Security alone accounts for 73 percent of retirement and disability expenditures, 44 percent of all entitlements spending, and nearly one-fifth of the entire federal budget. Although Social Security is funded by its own tax source, benefit reductions or tax increases in it would reduce the deficit (see Box II-1).

BOX II-1.
SOCIAL SECURITY AND THE DEFICIT

The Social Security Old Age, Survivor and Disability Insurance (OASDI) program is financed almost exclusively by a payroll tax that is "earmarked" for the sole purpose of paying benefits. The object of this arrangement is to achieve a long-run balance between program spending and the revenues earmarked for the program. When receipts exceed outlays--as they will in 1985--the surplus is not spent for other governmental purposes. Instead, it accumulates as a reserve in a Treasury account called a trust fund. When outlays exceed receipts, the reserve is drawn down.

Attaining long-run balance in the OASDI trust fund does not settle the question of whether the level of benefits and taxes is appropriate. Nor does long-term balance indicate the current impact on government borrowing. While the receipts of the OASDI trust fund are earmarked for specific purposes, they are nevertheless revenues of the federal government, just as trust fund spending counts as outlays of the government. In short, they are part of the unified budget. Thus, if spending from a trust fund is reduced, or if the rate of its earmarked tax is raised, the federal deficit will be lower, and the government will borrow less from the public.

There are sharp differences of opinion, however, about the deficit reduction role of lower spending or higher revenues in programs supported by dedicated taxes. Some argue, for example, that if the OASDI trust fund reserve should rise--as is currently the case--then Social Security would already be helping to lower the deficit and should not be called on to do more.

Others contend that the OASDI reserve is, in fact, inadequate to cover future liabilities, so they have no objection if it increases to higher levels than now projected. Indeed, the case can be made that surpluses in all accounts would help the economy finance Social Security when the baby boom retires after the turn of the century.

Yet a third approach argues that if benefit cuts cause the accumulation of an "excess" OASDI reserve, the answer is to shift the excess to the troubled Medicare HI trust fund, for example, or to lower the payroll tax rate but hike the income tax enough to prevent an overall revenue loss.

A number of the options discussed in Section II of this volume would lead to higher trust fund revenue or lower trust fund spending. The assumption in all such cases is that the difference would be devoted to lowering deficits.

Major legislation enacted in the last four years has restrained the growth in retirement and disability benefits, and has also increased the revenues used to finance them. Actions that affected spending included delaying cost-of-living adjustments (COLAs) in a number of programs; reducing the frequency of COLAs in the civil service and military retirement programs; and tightening Social Security eligibility for students and for certain recipients with older children. Revenues used to finance these programs were increased by moving forward scheduled increases in Social Security payroll tax rates and by taxing a portion of some recipients' Social Security benefits. Increased contributions were also required of railroad workers and their employers. Few programs have been expanded. One example is the 7 percent increase enacted in 1983 for basic SSI benefits.

The growth in net outlays for these programs could be slowed more by further limiting the number of people eligible to receive benefits, by restraining benefit levels for those who qualify, or by increasing revenues earmarked to pay for the benefits. One example of the first approach would be to eliminate Social Security benefits for children of people who retire before reaching age 65 (see ENT-14). Additional savings could be realized by eliminating veterans' compensation benefits for those with minor disabilities (see ENT-16).

The second strategy for slowing growth in outlays--reducing benefit levels--could be achieved in a number of different ways. The alternative that has received the most attention recently is to restrict COLAs available to retirees or disability annuitants. ENT-13 in Section II discusses several specific options for reducing COLAs, including: eliminating them for one year; limiting COLAs to two-thirds of the increase in the cost of living; providing COLAs only for cost-of-living increases in excess of 2 percent a year; and paying full COLAs only for low benefit amounts, while providing reduced adjustments for benefits that exceed that minimum. Generally, these approaches spread the burden over a large number of people but would only affect those who are already retired. Making parallel changes in the formula for indexing the benefits of future retirees would treat both groups more nearly the same and would increase long-term savings to the government.

The third approach to reducing net outlays for retirement or disability programs is to increase revenues earmarked to pay for benefits. One example is to require that all newly hired state and local government employees be covered by Social Security. This would increase payroll tax revenues in the short run but would make the Social Security system liable for additional payments as the new public employees reach retirement (see ENT-15).

Retirement programs for federal employees--both civilian and military--pose another set of policy choices. In addition to applying restraints on the indexation of benefits for current beneficiaries (discussed in ENT-13), further savings could be realized by changing provisions that make government retirement quite generous. Specifically, to lessen the budgetary cost of military retirement now available to people in their forties, the COLA for retirees below age 62 could be limited (see DEF-19). A similar reduction could be imposed on Civil Service Retirement payments in excess of $1,000 per month, and the formula for determining retirement benefits in that program could be curtailed for future retirees (see CIV-08).

Other Entitlements

Many widely differing programs make up the remainder of the entitlements component of the federal budget. These include: (1) non-means-tested programs, such as Unemployment Insurance, which provide benefits to qualifying individuals regardless of their incomes; (2) means-tested benefits, such as AFDC, Food Stamps, and Child Nutrition programs, where eligibility is generally limited to low-income people; and (3) some programs that provide grants to state or local governments to finance public services. Outlays under all these programs together are expected to total $75 billion in 1985 and $71 billion in 1990 if current policies are continued. [2]

Since 1980, numerous changes have been made in these programs by limiting eligibility and reducing benefit levels. Actions taken have limited the circumstances under which extended UI benefits are available; reduced AFDC benefits for most recipients with earned income; eliminated Food Stamp benefits for all households with incomes greater than 130 percent of the federal poverty guidelines, while lowering the allotments for those who remain eligible; reduced subsidies under most Child Nutrition programs; limited subsidized Guaranteed Student Loans to students from families with incomes below $30,000 and to others who can demonstrate financial need; and lowered funding for the Social Services Block Grant (which is financed under Title XX of the Social Security Act), while eliminating the requirement that states use funds to benefit low-income people.

Spending under these programs could be further reduced either by restricting eligibility or by limiting the benefit provided to each qualifying individual or jurisdiction. The non-means-tested programs, or those that are only partially means-tested, afford the greatest opportunities for realizing savings without reducing benefits to lower-income people. Specific exam-

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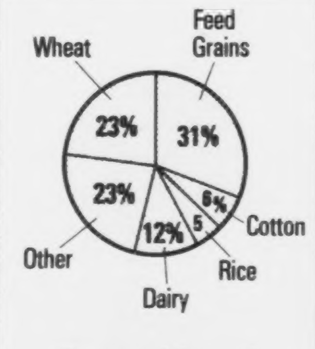
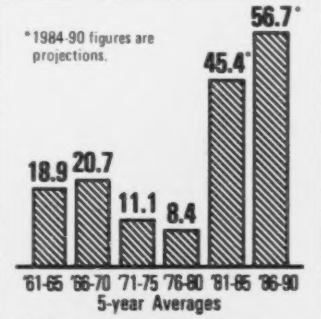
2. This comparison is distorted by the effect of a one-time outlay of $13 billion in 1985 for the refinancing of public housing projects.

ples include requiring a two-week waiting period before a person can receive Unemployment Insurance benefits; reducing the subsidy provided under the Guaranteed Student Loan program; and eliminating the subsidy for nonpoor children in Child Nutrition programs (see ENT-17 to ENT-20). In each instance, benefit reductions would fall most heavily on those in the best position to bear the loss. Applying a similar rationale, General Revenue Sharing, a grant program that provides funds on an entitlement basis to all local governments, could be made available only to those jurisdictions experiencing fiscal stress (see ENT-21).

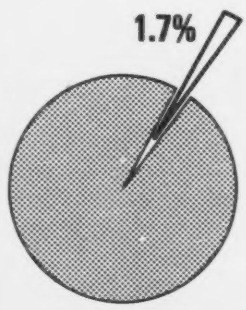
AGRICULTURAL PRICE SUPPORTS



Composition of 1985 Outlays



Price Support Outlays as Share of Net Farm Income 1961-90



1985 Share of Budget Outlays

Today's farm programs are under examination both because of their costs and because of their ineffectiveness in supporting and stabilizing farm prices and incomes. Outlays for agricultural price-support programs were $19.1 billion in 1983, higher than the record $11.6 billion in 1982 and nearly six times above the historical average. As shown in Table II-4, price-support outlays declined to $7.3 billion in 1984, but are estimated to rise to $16.1 billion in 1985, and to average $13.2 billion yearly over 1986-1990. (Key features of the programs are described in Box II-2.)

The run-up in outlays in 1982 and 1983 resulted from large crops in the face of stagnating export markets. Declining crop prices triggered large price-support outlays. In 1984 outlays declined because of reduced crops and correspondingly higher prices. Outlays are projected to rise for 1986-1989 mainly because exports are not expected to keep up with increased domestic supplies.

The surge in price-support outlays has not prevented the financial situation of many farmers from worsening in the 1980s. Persistently low farm income and declining farm land values in many regions have created severe financial stress among farmers carrying large amounts of debt. Many of these operators bought land in the 1970s expecting continued favorable rates of return. Those in difficulty include approximately 10 percent of the nation's farm operators who hold about 40 percent of farm debt and have debt-to-asset ratios larger than 40 percent. They are among the nearly 30 percent with farms having annual sales of $40,000 or more. Farms of that size account for about 90 percent of farm output.

TABLE II-4. BASELINE PROJECTIONS OF OUTLAYS FOR AGRICULTURAL PRICE-SUPPORT AND RELATED EXPENDITURES, FISCAL YEARS 1984-1990
(In millions of dollars)

	Actual	Estimated	Baseline Projections				
Program	1984	1985	1986	1987	1988	1989	1990
Major Crops							
Wheat	2,540	3,750	2,950	3,850	3,850	3,800	3,750
Feed grains a/	-760 b/	4,900	3,200	4,750	4,550	4,400	4,050
Cotton	240	1,000	650	770	600	500	440
Rice	330	810	390	590	625	670	720
Dairy	1,500	1,950	1,700	1,650	1,500	1,300	1,200
Other c/	3,450	3,650	3,050	3,000	2,450	2,300	2,500
Total	7,300	16,050	11,950	14,600	13,550	12,950	12,700

SOURCE: Congressional Budget Office.

NOTE: Totals may not add because of rounding.

a. Mostly corn.

b. Minus denotes receipts

c. Includes wool and other commodity programs, and administrative and nonadministrative expenses.

BOX II-2.
AN OVERVIEW OF FARM PRICE SUPPORT

Price-support expenditures are made through a number of commodity programs designed with two principal objectives: (1) to stabilize farm prices and income, and (2) to increase farm income. The main price stabilization tools are nonrecourse loans and the farmer-owned grain reserve.

Nonrecourse loans are made to crop farmers at a specified loan rate, or price support, per unit of production. Farmers may store crops and use them as collateral for 9- to 12-month loans at the loan rate. If a farmer elects not to repay the loan plus interest, the government agrees to accept the commodity as full reimbursement. Thus, nonrecourse loans place a floor under market prices, provide a source of interim financing for farmers, and help farmers spread their sales throughout the marketing year.

Under the reserve program, a wheat or feed grain grower contracts with the government to store grain for a three-year period and receives a nonrecourse loan and annual storage payments. Grain in the reserve cannot be sold, except with a financial penalty, until the market price reaches a trigger release price, at which time storage payments cease and farmers can repay loans without financial penalty. Interest is charged only for the first year.

Milk prices are supported by government purchases of surplus manufactured dairy products. The support price for milk determines the government purchase prices for these products. The support price places a floor under market prices.

The principal tools for income support are deficiency payments and reductions in planted acreage. Deficiency payments support the incomes of feed grain, wheat, rice, and cotton farmers when national average prices for a specified period fall below target prices. The maximum payment per unit of production is the difference between the target price and the nonrecourse loan rate.

Reductions in planted acreage from predetermined base levels may also be required of grain and cotton farmers to qualify them for the above program benefits. Further, these farmers may be offered land diversion payments in cash or in kind for additional acreage reduction. The total amount of deficiency and cash diversion payments that an individual can receive under one or more of these crop programs is $50,000 a year.

Agricultural price-support programs are entitlement programs that require the payment of benefits to any eligible individual. Outlays for these programs are highly variable; they move in an opposite direction from year-to-year changes in farm prices and incomes.

Today's farm programs are much the same as they were 50 years ago at their inception, although U.S. agriculture has changed dramatically:

- A large share of agricultural production today is carried out by a relatively small number of large, specialized, capital-intensive farms; the majority of farm families depend on off-farm sources of income.
- Farming is now integrated with the rest of the economy and is strongly influenced by overall economic policies. Farmers purchase most of their materials and equipment off the farm; they borrow in the capital markets; and they earn much of their income from off-farm employment.
- Farmers producing the major crops now depend on uncertain international markets for a substantial portion of their sales. This means that their prices and incomes are very sensitive to changes in weather, agricultural production, and government policies abroad.

Limitations of Farm Programs

Because of these changes in agriculture, farm programs have been progressively less able to achieve their objectives of supporting and stabilizing farm prices and incomes. Moreover, the direct benefits they provide go primarily to large producers. Many farmers produce only small amounts of the commodities supported by the government or do not produce any of them.

Government efforts to increase farm prices and incomes by enrolling farmers in voluntary acreage reduction programs have been less effective than was hoped. Other programs have also been disappointing. For example, the farmer-owned grain reserve was intended to stabilize prices for farmers and consumers. But in the 1980s it has been used to raise prices by reducing readily available market supplies, which led to large government stocks and outlays while only temporarily raising prices. The dairy price-support program is another example of a program intended as a price stabilization tool that has been used to raise prices at considerable cost to the taxpayer.

Budget Reduction Strategies

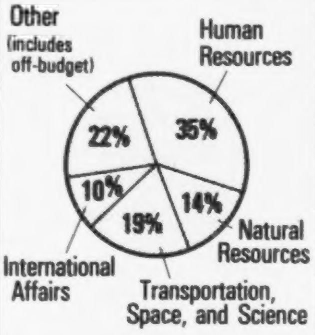
Agricultural price-support outlays could be reduced in several ways, depending on farm policy objectives. For example, if raising farmers' incomes is a major concern, there are at least two potential strategies for doing so. One would be to place controls on crop production in order to boost prices and incomes, thereby reducing price-support outlays. This approach would transfer the costs of supporting farm income from taxpayers to consumers. Most likely, it would also impair agricultural exports. The benefits would go to a relatively small number of large farmers and to landowners, many of whom are not farmers. Estimated savings over 1986-1990 would be $20.8 billion (see AGR-01 in Section II).

Another strategy for supporting incomes would be to target deficiency payments on small- and medium-size farms. This would reduce payments to large-scale farms. A $10,000 payment limit per individual, as compared with the current $50,000 limitation, would reduce estimated outlays by $4 billion over 1987-1990 (see AGR-02).

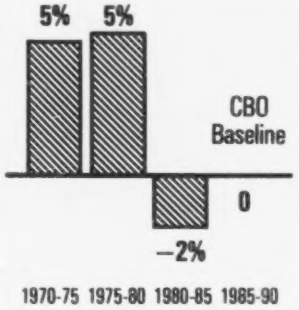
Alternatively, if the objective is only to stabilize farm prices and incomes, allowing their levels to be set by market forces, this might be approached through flexible price supports, the elimination or phasing out of deficiency payments, and less reliance on government stocks. (This could be integrated with a targeting of deficiency payments to low-income farmers.) Estimated savings from the elimination of deficiency payments would be $28.9 billion over 1986-1990. Savings from a phased-in elimination of these payments could total $17.4 billion over 1986-1990. To help farmers cope with income instability, very low-cost insurance programs could be instituted. (See the CBO report, *Canada's Western Grain Stabilization Program*, November 1984.) Such programs would involve some costs to taxpayers, but would offer net savings as compared with continuing current policy (see AGR-03).

Dairy price-support outlays could also be lowered by reducing the level of price support until government purchases averaged about 2 percent of annual milk production. This price stabilization policy would reduce estimated outlays by $3.0 billion over 1986-1990 (see AGR-04).

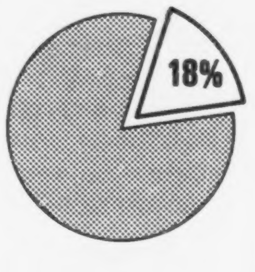
NONDEFENSE DISCRETIONARY SPENDING



Composition of 1985 Outlays



Annual Change in Real Outlays, 1970-90



1985 Share of Budget Outlays

Many nondefense programs are called "discretionary" in that the law establishes no entitlement to benefits from them. Such programs comprise all spending subject to annual appropriations or to loan limits imposed in appropriation acts. Unified budget outlays for this spending category are projected to amount to $168 billion in fiscal year 1985, accounting for 18 percent of total baseline budget outlays (see Table II-5). An additional $11 billion will be spent on off-budget programs in this area.

Nondefense discretionary programs support a very wide variety of activities, ranging from foreign aid to legal services (see Box II-3). The largest portion of the spending--over one-third--goes for human resources programs--for example, education, job training, and health subsidies. The next largest portion--about 15 percent--finances transportation programs, such as highways and mass transit. The remainder of the spending is divided among international affairs; natural resources; community, regional, and business development; general government; and space and science programs.

From the early 1960s through 1980, overall spending for nondefense discretionary programs grew both in actual amounts and as a percentage of GNP. Since 1980, however, nondefense discretionary spending has declined in real terms, as a percentage of the federal budget, and as a share of GNP.

TABLE II-5. FEDERAL OUTLAYS FOR NONDEFENSE DISCRETIONARY SPENDING (By fiscal year, in billions of dollars)

	Actual		Estimated	Baseline Projections				
Subcategory	1980	1984	1985	1986	1987	1988	1989	1990
Human Resources	52.6	57.7	62.4	65.9	69.1	72.3	75.8	79.5
Natural Resources	23.7	24.3	24.8	25.2	25.5	26.2	27.1	28.1
Transportation	21.0	23.2	25.6	27.7	29.5	30.3	31.6	32.7
Community, Regional, and Business Development	17.0	13.7	13.5	12.9	13.2	13.7	14.3	15.6
International Affairs	10.9	13.8	18.2	18.1	19.5	20.4	20.8	21.6
General Government	9.6	12.0	14.3	14.8	16.3	18.4	20.6	23.2
Space and Science	5.7	8.3	8.7	9.0	9.2	9.6	10.0	10.4
Budget Outlays	140.6	152.9	167.6	173.7	182.2	190.8	200.1	211.2
Off-Budget Outlays	14.2	10	11.1	8.6	8.1	8.4	6.2	6.2
Total Outlays	154.9	162.9	178.7	182.3	190.4	199.2	206.4	217.4

SOURCE: Congressional Budget Office.

BOX II-3.
SUBCATEGORIES OF NONDEFENSE DISCRETIONARY SPENDING a/

Human Resources. Includes education, training, employment, health, income security, and veterans' programs (see NDD-20 through NDD-25).

Natural Resources. Includes programs concerning energy, water resources, land and park management, pollution control, and agriculture (see NDD-05 through NDD-09).

Transportation. Includes ground, air, and water transportation programs (see NDD-12 through NDD-17).

Community, Regional, and Business Development. Includes community development programs, major housing credit programs, the postal service, and other business and regional development programs (see NDD-10, NDD-11, NDD-18, and NDD-19).

International Affairs. Includes economic and military assistance to foreign governments, contributions to international organizations, and international financial programs (see NDD-01 through NDD-03).

General Government. Includes funds for the administration of justice, the legislative branch, the Internal Revenue Service, the General Services Administration, general purpose fiscal assistance, and civilian pay raise projections (see NDD-26).

Space and Science. Includes funds for the activities of the National Aeronautics and Space Administration, the National Science Foundation, and other basic science research support (see NDD-04).

Off-Budget Programs. Includes the Federal Financing Bank, the Strategic Petroleum Reserve, and other activities not captured in the unified budget.

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a. Each category excludes entitlements and other mandatory spending programs. The material in parentheses refers to specific options in Section II.

This reduction has been accomplished by limiting spending in most areas, particularly in training, employment, and community development programs. The CBO baseline assumes that spending on these programs will remain constant, when adjusted for inflation, through the end of the decade, and thereby continue to decline as a percentage of overall federal spending.

Ideally, any effort to reduce further federal nondefense discretionary spending should begin with wasteful, outmoded, or inefficient programs. In practice, however, reducing spending in this area largely involves reducing the level of support provided for activities--ranging from education to infrastructure--that have merit. Thus, further cuts would require revising judgments about how much the federal government can afford to spend on these activities. Such an effort might be aided by considering four broad strategies for cutting these diverse programs:

- Shift responsibility to users of federally supported facilities;
- Shift responsibility to state and local governments;
- Alter and narrow targeting; and
- Restructure credit programs.

These strategies are applicable in different degrees to various programs. Other savings would result from measures designed to reduce the size and compensation of the civilian work force as described in the section on Federal Personnel, Management, and Construction.

Shift Responsibility to Users of Federally Supported Facilities

Many nondefense discretionary programs clearly benefit certain groups of users. One strategy to reduce spending would shift more of the cost of supporting such activities to their users. This could be accomplished by continuing to provide a service, be it postal, rail or space transportation, or air traffic control, while expanding user charges. Option NDD-15 in Section II, for example, discusses applying such a tactic to air traffic control services. Alternatively, the federal role could be even further limited to that of a paid contractor; users would choose, as well as pay for, the level of service provided. Examples of this approach are presented in limiting federal support for inland waterways and deep draft ports (see NDD-08 and NDD-09, respectively). Finally, subsidies could be reduced by simply reducing or eliminating federal support for some programs. The Congress could, for example, choose to stop or cut back assistance for commercial energy and aeronautical research and development, export industries, and the Bonneville Power Administration (see NDD-07, NDD-16, NDD-01, and NDD-06, respectively).

Many of these programs were instituted because the Congress believed that the private market would not generate an adequate volume of activity. But some analysts argue that, in many cases, the justification for providing services or subsidizing users has become less pressing over time. While only 11 percent of farms had electricity when rural electrification subsidies began, for example, now about 99 percent receive electricity. Similarly, the airline industry is no longer in its early stages of development; private companies might now be more willing to undertake, and more capable of paying for, the type of research and development necessary to keep the industry healthy.

Shift Responsibility to State and Local Governments

Another possible strategy for reducing federal spending would shift responsibility to state and local governments. The federal government currently shares responsibility for many programs with states and localities. In many cases, however, there is little clear federal interest, in that the benefits from the programs flow directly and completely to the localities. Moreover, even when the federal interest extends to assisting state and local governments, greater targeting of funds to needy jurisdictions may be warranted.

The Congress could choose to limit federal spending either by eliminating federal participation or by reducing the federal share of program costs in such areas as mass transit, highways, legal services, and education (see NDD-13, NDD-14, NDD-20, and NDD-26). Reducing federal participation might result in lower levels of overall support, and risk undersupport of some activities. But it might also lead to more efficient spending, by limiting the current distortions caused by the way federal aid is provided. (An often noted problem with many transportation programs, for example, is that they encourage relatively too much spending on new capital, rather than on maintenance or on improving existing service.)

Alter and Narrow Targeting

A third option would revise and narrow the direction of many programs. By focusing programs on those recipients most clearly in need of support, federal spending could be reduced while maintaining substantial levels of assistance. Restricting spending in this way could be accomplished in a variety of programs; NDD-18, NDD-21, and NDD-22 discuss the applications of this strategy to economic development and education programs.

Restructure and Limit Federal Credit Subsidies

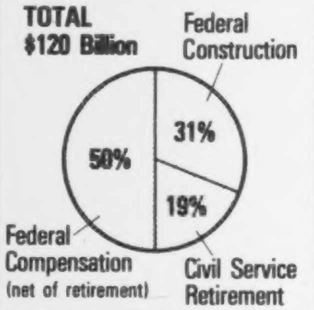
A fourth broad strategy for reducing nondefense discretionary spending would restructure and limit credit subsidies. New loan activity will amount to $117 billion in 1985. While economic conditions have limited spending on loan programs in the past several years--particularly in housing and international lending programs--substantial spending remains, a large portion of which is off-budget. In the case of direct loans, many interest rates were set when the Treasury's cost of borrowing money was much lower and have remained unchanged, causing the size of the subsidies and the cost to the government to grow. Because most government loan programs lack significant private participation, there are few incentives for careful credit review. The growth of such loan activity increases potential costs. (The costs of loan guarantees show up in the budget only when loans default, but current guarantees increase such potential future liabilities.)

The Congress could achieve budget savings in federal loan programs either by reducing the volume of loans extended through more stringent appropriation limitations, or by modifying the program authorizations to reduce the levels of subsidies. The fixed interest rates of the rural electrification, Bonneville Power Administration, and rural housing insurance loan programs could be raised to the Treasury's cost of borrowing or pegged at some lower figure that would maintain a specified subsidy (see NDD-05). (Budget outlay data for credit activities can be misleading measures of economic activity. See Congressional Budget Office, *New Approaches to the Budgetary Treatment of Federal Credit Assistance*, March 1984.)

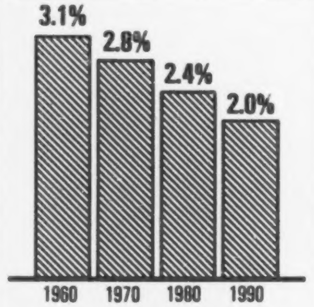
While these four strategies could be useful to the Congress in reducing federal spending in nondefense discretionary programs, they do not, in general, offer clear rules or prescriptions. Ultimately, the Congress would have to choose which programs to reduce. The list of options in Section II is intended to assist this selection process and to provide concrete examples of the type of cuts that would be needed to reduce nondefense discretionary spending. It in no way represents an exhaustive review of all federal spending in this area. Smaller programs and particular projects, for example, were beyond the scope of this study.

A further caveat must be placed on the options presented here: only programs in the CBO baseline are included, and thus only reductions from inflation-adjusted increases are considered savings. This caveat becomes particularly important when considering proposals to increase spending by expanding current programs, such as the space station under consideration by NASA. Reducing the scale of the proposed space station, for example, could represent a five-year saving of $3 billion relative to the Administration budget request. It is not included as an option, however, because it would not represent a savings compared to the CBO baseline.

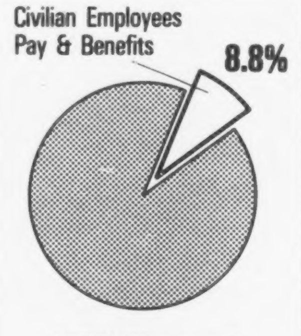
FEDERAL PERSONNEL, MANAGEMENT, AND CONSTRUCTION



Composition of 1985 Outlays



Federal Employment as Percent of Nonfarm Work Force



1985 Share of Budget Outlays

In 1985, the U.S. government will incur pay and benefit costs of $81 billion for its 2.2 million civilian employees (excluding employees of the U.S. Postal Service); spend $23 billion for benefits received by existing federal pensioners and survivors; and disburse $37 billion for construction projects. About 40 percent of these costs derive from the Department of Defense.

Cutting federal spending in many of these areas would require new legislation, as well as major action by the Executive Branch. The Congress, of course, could speed implementation through special oversight and appropriation action. Congressional involvement could also assure that associated savings would directly reduce budget deficits. The categories covered in this section include many subjects addressed by the President's Private Sector Survey on Cost Control (PPSSCC).

Size of the Work Force

The government's work-force requirements are determined by the demands of its programs, as authorized by the Congress, and by external factors that affect the work load. Aside from specific program changes discussed in other sections of this report (in particular see ENT-16 and NDD-24), a number of management improvements and related measures could reduce the number of federal civilian workers.

During the past decade (1974-1984), the number of federal civilian employees (nonpostal) rose by 7 percent--from 2.06 million to 2.21 million. Nondefense agencies, over that period, show the largest growth--slightly more than 8 percent, as compared with growth of defense agencies of about 6 percent. Civilian employment reached its highest levels in 1980 and 1984, having decreased and then increased again during the intervening years. About 124,000 jobs shifted from nondefense to defense agencies during this time. Federal employees now account for about 2 percent of the total nonfarm civilian work force, compared with 3 percent in 1960, despite the fact that federal spending rose from 18.5 percent of GNP to 24.3 percent in the same period.

Almost 50 percent of the civilian work force is engaged in Defense Department programs slated for expansion. Nearly 20 percent work at the Internal Revenue Service, the Veterans Administration, and the Social Security Administration, where work load continues to increase mainly because of demographic factors. The remaining one-third of the work force covers all other government activities. Despite such "structural" limitations, several management-type options are available that could eventually reduce the federal civilian work force significantly. A little over two-fifths of the reductions would be in the Department of Defense.

Proposals that restructure or reduce the civilian work force offer the greatest opportunity for economizing. Such proposals include correcting overgrading, reorganizing agency activities, streamlining personnel management, and increasing the use of private contractors (see CIV-01 through CIV-04). While management improvements sometimes require near-term increases in federal expenditure, these four options could reduce federal employment by the equivalent of 150,000 employees and result in savings of $8.6 billion through 1990. Another proposal to consolidate various DoD support activities and realign some military facilities could eventually eliminate 10,700 civilian employees and offer $0.6 billion in five-year savings (see CIV-05). Another 6,500 federal jobs could be eliminated by combining all major grant-in-aid programs into a handful of large block grants (see CIV-06).

Many analysts argue that reducing the federal work force through improved management techniques and other efficiencies would allow the government to provide the same level of services at a reduced cost. Opponents counter that further reductions might affect the level or quality of services. At a minimum, opponents argue, additional reductions could hinder governmental operations, lower employee morale, disrupt local economies, and impair public access to some facilities. Finally, substantial reduction of the work force would involve near-term costs from severance pay and other expenses associated with relocations and layoffs. Small reductions in federal employment are usually achieved by attrition, but large cutbacks would require substantial layoffs.

Compensation

The federal government incurs costs of $81 billion annually to compensate its employees. Nearly two-thirds of this amount is spent on pay; the remainder covers fringe benefits, including health and life insurance, workers' compensation, and civil service pensions that, on an accrual basis, represent about 63 percent of the cost of all fringes.

During the past decade, eight of the ten annual governmentwide pay adjustments have been less than that necessary to keep federal salaries comparable with those paid for similar jobs in the private sector, according to the President's Pay Agent. The Congress has also enacted several measures limiting civil service pension benefits, notably the size and timing of postretirement cost-of-living adjustments. Despite such actions, opportunities remain for further cutbacks. Pay rates could be frozen for a year--or even reduced, as proposed by the Administration--with significant short-term savings (see CIV-07). Other measures such as modifying the retirement program (see CIV-08) have a more solid analytic basis, but their potential near-term savings are not as large.

Government pay raises attempt to keep federal salaries comparable with those in the private sector. Many see that comparability, however, as a standard for evaluating both federal pay and benefits. This standard of "fairness" seems especially attractive because the federal government does not bargain collectively on compensation issues with its employees. Nevertheless, for a number of reasons, it is difficult to compare the federal government's compensation package, and its major individual components, with those offered by private-sector employers.

One reason for this difficulty is that statistical comparisons of federal and private-sector pay are highly sensitive to survey design and interpretation. According to Hay Associates, an actuarial accounting firm specializing in employee compensation, federal salaries are 10 percent below those in the private sector; the President's Pay Agent finds them 18 percent below. The Hay Associates' calculations place equal weight on the pay practices of the various companies they survey, whereas the President's Pay Agent's calculations require job matching and emphasize larger firms. By contrast, the Office of Personnel Management (OPM) concludes that average federal salaries may be either 2 percent below those in the private sector or 11 percent higher, depending on the comparative framework used.

Believing that comparisons of federal and private-sector pay are too subjective, OPM advocates curtailing current pay rates at least until the government's voluntary quit rates rise more than threefold--from just under 4 percent to 12 percent per year. But any comparison of quit rates raises the same difficulties that occur in comparing pay--namely, determining the universe for comparison. In addition, federal retirement benefits that provide incentive for long federal careers, and cannot be transferred to private-sector employment, help hold down federal turnover. Finally, a higher federal quit rate would impose larger costs on the government for recruitment and training.

Despite the uncertainty surrounding comparisons of current pay levels, most analysts agree that many groups within the federal service face a large salary disadvantage compared with counterparts in the private sector, and that this is especially true for those in high-level jobs. They also agree that when rates of salary change are compared, federal pay has increased less than pay in the private sector. Since 1975, most federal salaries have increased at an average annual rate of 6.7 percent as compared with 7.1 percent increases for other white-collar employees. (During the same period, inflation averaged 7.4 percent.) The inflation-adjusted or real decline in federal salaries would have been even greater if not for a shift in the workforce requirements toward more skilled, trained, and experienced workers.

Opponents of proposals to cut federal employees' pay believe such action would diminish the government's ability to recruit and retain qualified personnel. Pay limitations could also increase "moonlighting" by federal personnel and thus could reduce productivity. Some also suggest that further pay limitations would compound an already existing problem--that the federal pay structure does not always reward employees based on merit. (Comprehensive changes to reward civilian employees on the basis of merit could increase costs in the short term. Such changes are being tested by the Navy in a demonstration project at two laboratories in California--at

China Lake and at San Diego. See Congressional Budget Office, *Reducing Grades of the General Schedule Work Force*, September 1984, pages 18-20 and 45-49.) The Administration and other proponents of cutting federal employees' pay argue, however, that federal employees receive certain nonpecuniary benefits that offset lower salary increases--such as job security, intragovernment mobility, and the portability of federal retirement benefits for workers transferring among federal agencies. They also maintain that lower federal compensation rates would diminish the government's competitive advantage relative to the private sector and, at the same time, bring fresh talent into the government.

Federal Construction

Federal spending for the construction and rehabilitation of physical assets amounts to $37 billion in 1985. About two-thirds of this--$24 billion--covers projects involving federal grants to state and local governments. The remaining $13 billion covers projects in which the government has primary responsibility for construction and design. (DoD accounts for about $5 billion of these direct federal construction expenditures, while water and power projects account for almost all of the remainder.) Direct construction expenditures have increased by 25 percent since 1980. When adjusted for inflation, however, total federal investment appears fairly stable, with increases for defense projects almost offsetting decreases for nondefense projects.

Some analysts believe the government could implement better management techniques to reduce construction costs. If some direct federal construction work were curtailed for three years while planning and procurement improvements were expanded, outlay reductions through 1990 could reach $1.4 billion (see CIV-12). The budgetary reductions from this action would result mostly from postponing rather than reducing construction. Costs for construction projects undertaken could be lowered by $0.6 billion through 1990 by controlling the number and cost of contract changes.

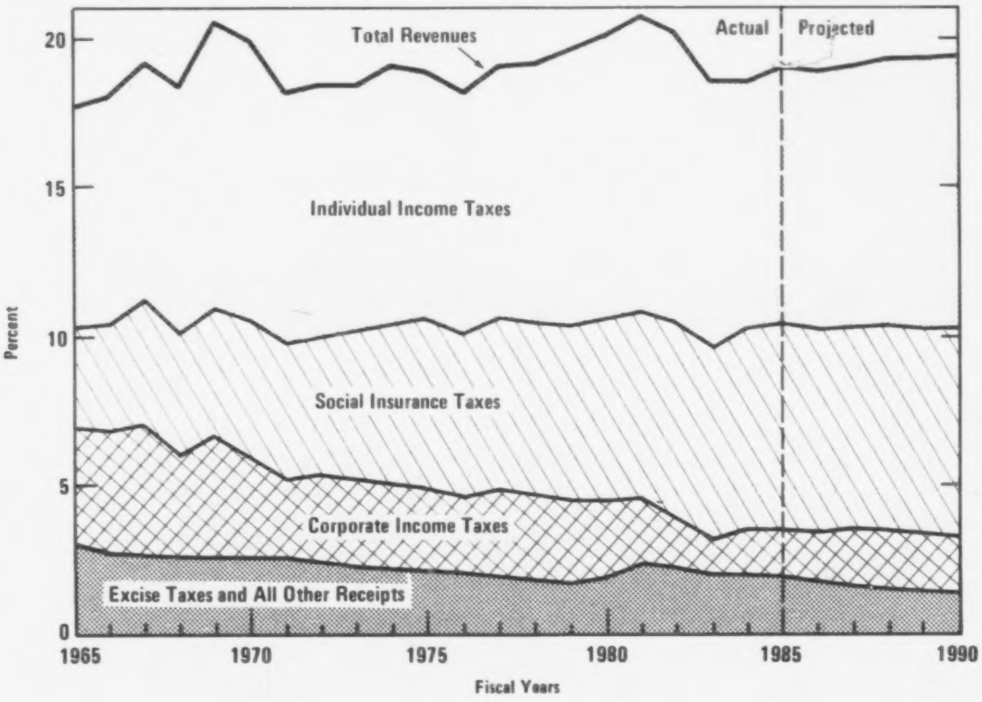
Further reductions could be achieved by allowing private-sector employers more flexibility in setting overtime provisions for their employees engaged in federally funded construction projects and in the production of goods purchased by the federal government. Savings from proposals to modify statutory requirements would result from reducing total overtime costs and from increasing the number of private-sector companies that may bid for each job (see CIV-13).

REVENUES

Federal revenues, under laws now in place, are projected to rise slightly from 19.1 percent of GNP in 1985 to around 19.4 percent in 1990, which is about the average for the period since 1960 (see Figure II-5). Historically, revenues have fluctuated with the state of the economy, rising relative to GNP in periods of growth and falling in times of recession. Revenues have also been reduced during recessions by tax cuts designed to stimulate the economy, and (more rarely) increased by tax rises in times of rapid growth and inflation or when deficits were large.

Since 1960, the contribution of different federal taxes to total revenues has shifted markedly (see Table II-6). The individual income tax has continued to yield between 40 percent and 50 percent of total revenues, but the share of the corporate income tax has dropped from 23 percent to 8.5 percent (up from the shares in 1982 and 1983) and that of social insurance taxes has increased from 16 percent to 36 percent.

Figure II-5.
Revenues by Source as Percents of GNP



The Congress has passed three pieces of broad-based tax legislation in the last four years. The first of these bills--the Economic Recovery Tax Act of 1981 (ERTA)--substantially reduced individual tax rates and liberalized the tax treatment of business investment. The second--the Tax

TABLE II-6. FEDERAL REVENUES BY SOURCE AS PERCENTS OF TOTAL REVENUES, 1960-1984 (By fiscal year)

Year	Individual Income Taxes	Corporation Income Taxes	Social Insurance Taxes and Contributions	Excise Taxes	Estate and Gift Taxes	All Other Receipts	Total Receipts
1960	44.0	23.2	15.9	12.6	1.7	2.5	100.0
1961	43.8	22.2	17.4	12.6	2.0	2.0	100.0
1962	45.7	20.6	17.1	12.6	2.0	2.0	100.0
1963	44.7	20.3	18.6	12.4	2.0	2.1	100.0
1964	43.2	20.9	19.5	12.2	2.1	2.1	100.0
1965	41.8	21.8	19.1	12.5	2.3	2.6	100.0
1966	42.4	23.0	19.5	10.0	2.3	2.8	100.0
1967	41.3	22.8	22.0	9.2	2.0	2.7	100.0
1968	44.9	18.7	22.2	9.2	2.0	3.0	100.0
1969	46.7	19.6	20.9	8.1	1.9	2.8	100.0
1970	46.9	17.0	23.0	8.1	1.9	3.0	100.0
1971	46.1	14.3	25.3	8.9	2.0	3.4	100.0
1972	45.7	15.5	25.4	7.5	2.6	3.3	100.0
1973	44.7	15.7	27.3	7.0	2.1	3.1	100.0
1974	45.2	14.7	28.5	6.4	1.9	3.3	100.0
1975	43.9	14.6	30.3	5.9	1.7	3.7	100.0
1976	44.2	13.9	30.5	5.7	1.7	4.1	100.0
TQ a/	47.8	10.4	31.0	5.5	1.8	3.5	100.0
1977	44.3	15.4	29.9	4.9	2.1	3.3	100.0
1978	45.3	15.0	30.3	4.6	1.3	3.5	100.0
1979	47.0	14.2	30.0	4.0	1.2	3.6	100.0
1980	47.2	12.5	30.5	4.7	1.2	3.9	100.0
1981	47.7	10.2	30.5	6.8	1.1	3.6	100.0
1982	48.2	8.0	32.6	5.9	1.3	4.0	100.0
1983	48.1	6.2	34.8	5.9	1.0	4.0	100.0
1984	44.8	8.5	35.9	5.6	0.9	4.2	100.0

SOURCE: *Federal Government Finances, 1984 Budget Data*, various years, February 1984.

a. TQ = Transition quarter.

Equity and Fiscal Responsibility Act of 1982 (TEFRA)--reversed a portion of ERTA's business tax reductions and further increased revenues through improved compliance, selective excise tax increases, and other provisions. TEFRA reflected Congressional concern over high and rapidly rising budget deficits, and met its 1983-1985 revenue-increase goal almost precisely. However, one of its major provisions--withholding on interest and dividends--was repealed by the subsequent Congress. The third bill--the Deficit Reduction Act of 1984 (DEFRA)--will raise revenues by limiting or eliminating a variety of tax benefits and further extending and increasing some excise taxes. In addition, the Social Security Amendments of 1983 accelerated payroll tax rate increases.

Revenues fell from 20.1 percent of GNP in 1980 to 18.6 percent in 1984. This reflected the extremely slow growth of revenues resulting from the 1981-1982 recession, reduced inflation, and the enactment of ERTA. Revenues from the individual income tax grew slowly over the years 1980-1983, those from corporate income taxes fell precipitously, and those from social insurance taxes rose steadily (see Table II-7). Some of these trends were reversed in 1984. Corporate income tax revenues increased significantly from their low in 1983, largely because of the economic recovery.

The CBO projects that GNP growth will be slower in 1985 than in 1984, but that it will continue at an average annual rate of 7.8 percent through 1990, leading to continued increases in revenues. Revenues are expected to increase slightly from 19.1 percent of GNP in 1985 to 19.4 percent in 1990 as a result of the growth in real incomes. Outlays are also projected to increase slightly, from 24.3 percent of GNP in 1985 to about 24.6 percent in 1990. The net effect will be only a small decline in the budget gap.

Increases in tax revenues could have a large and immediate effect on the deficit. Some believe, however, that the deficit should be reduced only by cutting spending. They hold that tax increases tend to dampen economic growth, and hope that growth itself will play a major role in reducing the deficit. They also point out that federal spending as a share of GNP is at historically high levels (23.5 percent in 1984 compared with 18.5 percent in 1960 and 22.4 percent in 1980), while federal revenues as a share of GNP are in the range they have been for most of the past 25 years. They fear that additional revenues would be used to pay for new or increased spending programs instead of being applied to the deficit.

Even some of those who would prefer not to raise revenues, however, are prepared to do so in light of the large and growing deficit. Advocates of tax increases fear that the deficit will slow and distort the pattern of economic growth and unfairly burden future generations, and believe that spending cuts alone cannot reduce the deficit enough. They also point out that much of the long-term growth in the federal spending share is attributable to increases in entitlement benefits financed by payroll taxes; nonpayroll tax revenues as a share of GNP are low compared with the 1960s and 1970s. Finally, they note that the effects of tax increases on investment and economic growth depend on the specific form that the increases take, and that a careful choice of tax measures would go far toward minimizing any adverse effects.

TABLE II-7. FEDERAL REVENUES BY SOURCE, 1980-1990

Revenue Source	Actual		Estimated	Baseline Projections				
By Type of Tax	1980	1984	1985	1986	1987	1988	1989	1990
In Billions of Dollars								
Individual Income	244.1	298.5	333.7	361.4	392.9	432.1	471.2	514.7
Corporate Income	64.6	56.9	62.5	71.1	88.5	96.2	101.8	107.3
Social Insurance	157.8	239.4	265.5	284.2	301.3	333.4	357.7	389.0
Excise	24.3	37.4	37.7	34.5	35.0	33.9	33.5	34.2
Estate and Gift	6.4	6.0	5.6	5.3	5.0	4.7	4.7	5.1
Customs Duties	7.2	11.4	12.5	13.3	13.8	14.5	15.2	15.9
Miscellaneous	12.7	17.0	18.0	18.5	18.8	19.4	20.3	21.5
Total	517.1	666.5	734.9	788.4	855.2	934.2	1,004.5	1,087.6
As a Percent of Total Revenues								
Individual Income	47.2	44.8	45.3	45.8	45.9	46.2	46.9	47.3
Corporate Income	12.5	8.5	8.5	9.0	10.3	10.3	10.1	9.9
Social Insurance	30.5	35.9	36.1	36.1	35.2	35.7	35.6	35.8
Excise	4.7	5.6	5.1	4.4	4.1	3.6	3.4	3.1
Estate and Gift	1.2	0.9	0.8	0.7	0.6	0.5	0.5	0.5
Customs Duties	1.4	1.7	1.7	1.7	1.6	1.6	1.5	1.5
Miscellaneous	2.5	2.5	2.5	2.3	2.2	2.1	2.0	2.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
As a Percent of GNP								
Individual Income	9.5	8.3	8.6	8.7	8.8	8.9	9.1	9.2
Corporate Income	2.5	1.6	1.6	1.7	2.0	2.0	2.0	1.9
Social Insurance	6.1	6.7	6.9	6.8	6.7	6.9	6.9	6.9
Excise	0.9	1.0	1.0	0.8	0.8	0.7	0.6	0.6
Estate and Gift	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Customs Duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Total	20.1	18.6	19.1	19.0	19.1	19.3	19.3	19.4

SOURCE: Congressional Budget Office.

If the Congress chooses to raise revenues, several alternatives are available. Existing taxes (the income tax, payroll taxes, and taxes on consumption in the forms of excise taxes and user fees) could be raised, or new taxes (such as a national sales or value-added tax) could be created to supplement or replace existing taxes. In either case, the Congress would have to make decisions regarding the rate of tax and the base to which rates are applied.

Within these broad alternatives, there are many specific options for raising revenues. The question is how to choose among them. First, priority should be given to effective revenue raisers--those that raise revenues at relatively little cost in taxpayer compliance and governmental administration. Second, options that are effective revenue raisers should be evaluated in terms of their effects on economic efficiency. All else being equal, a tax that does not greatly distort economic incentives is obviously preferable to one that alters them. Taxes can distort economic incentives in several ways. They may affect the choice between work and leisure by reducing the after-tax wage rate; they may affect the choice between spending and saving by altering the after-tax return to saving; or they may affect the choices among investment alternatives by shifting the pattern of rates of return and risk. Third, options should be evaluated in terms of equity: they should tax equally those with equal ability to pay, and should tax those with differing ability to pay in a way that reflects the differences fairly. Unfortunately, most tax options fail to achieve all these goals simultaneously. Choosing among them involves striking a balance among conflicting objectives.

Increases in Existing Taxes

Higher revenues can be obtained from the existing income tax through rate increases for individuals and corporations (see REV-01 and REV-03 in Section II). These are easy to implement and administer, and spread the increased revenue burden among all taxpayers. On the other hand, rate increases exacerbate the economic distortions that result when people alter their economic behavior in order to reduce their tax liability. Higher marginal rates tend to discourage work effort, savings, and investment by reducing after-tax returns to these activities. They also increase efficiency losses from tax provisions that allow exemptions or deductions for selected forms of compensation, types of spending, investments in industries or assets, and forms and locations of business organization. Finally, rate increases fall heaviest on those least able to use these special tax provisions, thereby raising a question as to the equity of this strategy.

Rates can also be raised over time by eliminating, postponing, or otherwise modifying the indexing of the tax system for inflation (see REV-02). Without indexing, inflation-induced increases in nominal incomes raise individual tax revenues as a share of income by pushing taxpayers into higher tax brackets. As a result, average and marginal tax rates for most taxpayers are increased over time without explicit legislation.

Broadening of the Income Tax Base

In theory, under an income tax all income (net of the costs of earning it) should be included in the tax base. In practice, the base of the existing income tax has been reduced by exclusions of certain kinds of income from tax and deductions of certain expenses from income otherwise subject to tax. In addition, tax credits for selected people and activities further reduce revenues (though they do not diminish the tax base). These exclusions, deductions, and credits (referred to as tax preferences) have three general purposes: to provide incentives for certain economic activities (such as deductions to encourage charitable giving, or credits and accelerated deductions for selected kinds of investment), to provide tax benefits to selected groups of taxpayers (such as extra exemptions for the aged and blind and exclusion of a portion of unemployment insurance benefits), or to compensate taxpayers for mismeasurement of income (such as the exclusion of a portion of long-term capital gains, which is sometimes justified as a rough attempt to avoid taxing the inflation component of long-term capital gains).

The expanded use of existing tax preferences and the enactment of new preferences have narrowed the tax base significantly. Taxable income in 1984 was about 80 percent of total personal income, compared with over 90 percent in 1950. This erosion of the income tax base has made increases in tax rates necessary simply to allow the level of revenues to keep pace with income.

Another result of the proliferation of tax preferences has been an increasingly complex tax code. Each preference has its own set of rules, explanations, and exceptions that complicate the economic activities of many taxpayers, increase costs of compliance, and foster a growing perception that the income tax is unfair.

Reducing or eliminating tax preferences would raise large amounts of revenue. Base-broadening tends to improve economic efficiency by making the tax system more neutral among different ways of investing, earning, and spending money. This allows economic decisions to be guided more by the marketplace and less by the desire to reduce tax liabilities. For any level of total revenues, base-broadening also enables tax rates to be lower than they would be with a narrower base, which can further contribute to economic efficiency. Many base-broadening proposals also tend to improve the fairness (both actual and perceived) of the tax system, which may improve compliance. By eliminating tax preferences, base-broadening can simplify economic planning, as well as tax forms, and also reduce opportunities for legal tax shelter activity. Finally, although the costs of compliance vary depending on the specific base-broadening provision, many provisions would actually lower compliance and enforcement costs.

Base-broadening has some disadvantages, however. Though generally beneficial to the economy as a whole, base-broadening proposals can significantly increase the tax liabilities of those who previously benefited from tax preferences. Base-broadening may also reduce economic incentives for activities that the Congress wishes to subsidize, such as charitable giving, state and local public services, homeownership, and historic preservation, among others. Adjustment problems may be very severe in the short run, as labor and other resources shift among sectors in response to new tax incentives. Base-broadening may also have negative long-term effects on the economy. For example, many base-broadening provisions would reduce after-tax returns on investment and therefore reduce overall incentives for capital formation, even though they would cause the capital stock to be allocated more efficiently among activities.

Another disadvantage of base-broadening is that it could potentially cause windfall losses for some investors. Market prices of assets tend to reflect the value to investors of expected tax preferences related to the assets. For example, prices of homes are higher than they would be if there were no tax incentives for homeownership. When tax preferences are eliminated, asset prices may fall. Such windfall losses represent a serious equity problem: those who would suffer the windfall loss when tax preferences are eliminated are generally not the same people who benefited from windfall gains when tax preferences were instituted. Moreover, some investors who have borrowed to finance asset purchases would be left with debts that could not be liquidated by selling the assets.

Relationship of Base-Broadening to Tax Reform Proposals. Many tax reform proposals being discussed in the Congress can be categorized as "modified flat taxes." These include broad-based income taxes with flatter but graduated rates; graduated personal expenditure taxes (sometimes referred to as consumed income or cash-flow taxes); and pure "flat rate" taxes on income, personal expenditures, or sales.

Such tax reform proposals generally include more than simple base-broadening. The income tax proposals may broaden the base in some ways, but they also narrow the base to correct for real and perceived inequities resulting from mismeasurement of economic income. For example, the present income tax overstates capital gains income during times of inflation, and many proposals would narrow the tax base by allowing taxpayers to adjust costs for inflation before computing capital gains (indexing the basis). Another example under the present income tax is the double taxation of the dividend income of corporate shareholders, which could be reduced either by allowing corporations to deduct dividend payments or by allowing dividend recipients to claim a credit for corporate taxes paid.

Since a number of special tax code provisions are designed to compensate for problems of measuring income, base-broadening must be done carefully if the results are to be equitable and socially desirable. For example, if the capital gains exclusion were removed without indexing the basis of gains, capital gains income would effectively be taxed at marginal rates far higher than the statutory rates applied to ordinary income.

The tax reform proposals under consideration would not necessarily raise revenues. They also include reduced tax rates and other provisions that would tend to offset revenue gains from base-broadening. In fact, most of the proposals have been designed to be revenue neutral, meaning generally that they would collect about the same aggregate revenues as the present income tax, at least in the first year or few years following reform. The notion of revenue neutrality is not well defined, however. Some tax reform proposals contain base-broadening provisions that would probably affect payroll taxes as well as the income tax. Thus, even a plan called revenue neutral, in the sense that revenues from the income tax would be unchanged, could yield additional revenues overall. Moreover, a plan that is revenue neutral in the short run may increase or decrease revenues over time to the extent that it contains provisions either deferring or advancing tax liabilities. Finally, revenues will also be altered as people change their spending, saving, and investment behavior in response to the new tax law. These behavioral effects are very difficult to quantify.

Tax reform can be a first step toward raising revenues. Once the tax base is broadened, any increase in tax rates can yield larger amounts of revenue than under current law, with a smaller impact on economic efficiency. (It could, however, add significantly to the burden of those already hit hardest by revenue-neutral tax reform.) Alternatively, revenues could be raised through a partial reform of the existing tax system that eliminated or reduced some tax preferences while maintaining or only slightly reducing the current tax rate structure. Whether tax reform precedes, follows, or occurs simultaneously with revenue increases, it is clear that broadening of the tax base would enable more revenue to be raised with lower tax rates.

Across-the-Board Reductions in Tax Preferences. Some proposals call for across-the-board percentage cuts in tax preferences, in an attempt to broaden the tax base and raise revenues without targeting the tax preferences of specific groups of taxpayers. Under such proposals, those who currently benefit from tax preferences would pay the additional revenues. These proposals are generally intended to be temporary and are designed to increase income tax revenues over a five-year period (see REV-33). Another approach to across-the-board cuts in tax preferences is to establish or increase individual and corporate "minimum taxes" on tax preferences (see REV-34). Minimum taxes preserve tax preferences, but reduce their value and limit their use by any one taxpayer.

These proposals can potentially raise large amounts of revenues. They may also be perceived as more fair than item-by-item base-broadening, since they do not single out particular activities for tax increases. Moreover, they would probably involve smaller losses in economic efficiency than would rate increases. On the other hand, across-the-board cuts in preferences might limit the ability of the Congress to reduce selectively those incentives it deems to be of the lowest social and economic priority.

Sales and Excise Taxes

A final alternative for raising revenue is to place new taxes on consumption or increase existing excise taxes. In 1984, sales and excise taxes accounted for only 5.6 percent of federal revenue; this share is projected to decline to 3.1 percent in 1990. In 1984, about 24 percent of federal sales and excise taxes revenues were attributable to the crude oil windfall profit tax, a temporary excise tax on increased revenues from domestic crude oil production. This tax was imposed in 1980 to accompany decontrol of crude oil prices. Revenues from the windfall profit tax have been much less than originally anticipated because of the decline in world oil prices, and the tax is scheduled to be phased out at the end of 1991.

General Taxes. The federal government currently does not impose a general sales tax, although 45 states impose general retail sales taxes at rates varying from 2.0 percent to 7.5 percent, and some localities impose additional taxes. Most other industrialized countries, however, rely quite heavily on broad-based consumption taxes for revenues. A significant amount of revenue could be raised by imposing a new general sales tax, in the form of either a retail sales tax or a value-added tax (VAT). The two taxes would be similar in incidence and in economic effects, but would differ in the method of collection. Under a retail sales tax, the entire tax would be collected as a fraction of the proceeds of sales to "final" consumers. Under a VAT, the tax would be collected on the proceeds of sales at each stage of the production process, with sellers allowed a tax credit for VAT taxes already paid on goods and services purchased from other firms. Under both types of sales tax, sales of capital goods and of exports would be effectively tax-exempt and the base of the tax would be final consumption by U.S. residents.

The main advantage of relying on sales and excise taxes for raising additional revenue is that sales taxes do not directly reduce the after-tax return on saving and, therefore, can be presumed to be more favorable than income taxes to saving and capital formation. Moreover, a broad-based general sales tax would cause few economic distortions since it would treat all items of consumption similarly. For this reason, new taxes on consumption may be preferred to increases in the tax rates imposed on the base of the current highly imperfect income tax. The case is less clear cut if there are large exemptions from a general sales tax.

A major concern is the effect a consumption tax would have on the price level. A sales tax would increase prices relative to wages, interest, and rent (factor incomes). The extent to which nominal prices would rise or factor incomes decline is uncertain. Any increase in the price level would be a one-time phenomenon and not a permanent increase in the annual inflation rate. There could be some inflationary effects beyond the first year, however, because of cost-of-living escalator clauses in some contracts and indexing of benefit programs.

To the extent that prices rose, substitution of a sales tax for an increase in income taxes would tax unfairly the savings of those who accumulated wealth prior to the sales tax. When these taxpayers purchased goods and services with their savings after the tax-induced price increases, they would have paid both income taxes on their prior earnings and sales taxes on the use of those earnings. One group probably subject to such losses is the elderly. In contrast, those who did not accumulate savings before the sales tax would have paid only the income tax on their prior earnings. The effect of a new sales tax on the elderly would be partially offset by the indexing of Social Security benefits, which are linked to price-level changes such as those that would be induced by the tax.

Another disadvantage of sales taxes is that they are regressive. They must be imposed at a single rate for all taxpayers, and consumption generally takes a larger share of the income of low-income households than of high-income households. The existing data on consumption spending at various income levels may, however, overstate the regressivity of a sales tax. Some taxpayers with a high ratio of spending to income are only temporarily in the low-income brackets, while many in the upper brackets may have earned only temporary windfalls but continue at a lower rate of spending. In any case, the regressivity of sales taxes could be partially offset by exemptions for food and other "necessities" or by increases in food stamp and Medicaid benefits. Moreover, the indexing of federal transfer payments would protect recipients from any price increases that might be associated with a new or increased consumption tax.

A value-added or retail sales tax with exemptions for food, housing, and medical care could raise annual revenues (in 1986 dollars) of about $12 billion per percentage point of tax (see REV-05).

A general sales tax might be opposed by states, which would view the tax as competition for their traditional revenue sources. Such a tax would also require new enforcement procedures and possibly a significant increase in IRS personnel. Moreover, a new federal tax would probably take one or two years to implement. Finally, there is concern that such a tax might be "too effective" as a revenue raiser, stimulating excessive growth in the public sector. The latter consideration has led some to propose constitutional limits on the maximum tax rate under a federal sales tax.

Specific Taxes. An alternative to a general sales tax is a tax on selected items of consumption. In recent years, much consideration has been given to imposing new taxes on energy consumption, which are justified as measures to encourage energy conservation and reduce dependence on oil imports. Energy taxes have also been viewed as "painless" ways of raising revenues because they would merely offset recent declines in energy prices, rather than increase prices to new levels. Among the energy taxes that have been considered are taxes on oil imports, on all domestic oil consumption, on gasoline (beyond the taxes currently dedicated to the highway trust fund), and on energy consumption generally, measured either as the value or quantity of energy consumed. In addition, some revenue could be gained from an excise tax on decontrolled natural gas, either in the form of a tax on "windfall" revenues similar to the crude oil windfall profit tax or a flat-rate excise tax on domestic natural gas production (see REV-06).

Energy taxes would have some disadvantages in that they would single out particular industries and impose special burdens on certain classes of consumers and regions of the country. These special burdens would be difficult to justify without a compelling rationale, such as the national security interest in reducing levels of energy consumption. It could be argued, moreover, that stockpiling would be a more efficient way of insuring against a future oil supply disruption than reducing present energy consumption.

Additional revenues could also be raised by increasing federal excise taxes on tobacco, alcohol, and telecommunications beyond those already enacted in 1984, or delaying scheduled reductions in them. Alternatives include further extension of temporary rate increases, restoring rates on tobacco and alcohol taxes to historic levels, or indexing the specific tax rates on alcohol and tobacco to changes in the Consumer Price Index (see REV-07). Finally, there is potential for increasing revenues by raising certain user taxes, such as taxes on the use of inland waterways, deep draft navigation facilities, and Coast Guard services, so that user charges would fund a larger share of total outlays (see NDD-17).

Arguments for and against increases in selective excise taxes and user fees are particular to the goods being taxed. Proponents of increasing excise taxes on alcohol and tobacco point to social costs that result from consumption of these goods, including increased medical costs that are subsidized by taxpayers in general. These proponents also note that the real burden of these taxes has declined relative to historical levels because of inflation. Opponents of higher excise taxes point out that these taxes, because they are selective, interfere with private choice more than general taxes on either sales or income and that taxes on alcohol and tobacco are even more regressive than general sales taxes. User fees increase economic efficiency by forcing households and industries to confront the full costs of the scarce resources they use, but increases in user fees may cause dislocations in particular industries and regions.

Conclusion

If the Congress decides to reduce the budget deficit by increasing revenues, a wide variety of general approaches are available. These approaches differ in their effects on the distribution of income, on consumption and saving, and on the allocation of resources among industries. All of the approaches would impose some costs on the private economy, but in differing degree. Some types of revenue increases could arguably increase economic efficiency and fairness by making the tax system more neutral among different ways of earning, spending, and investing income, as well as by causing consumers to weigh the full social costs of the goods and services they propose to buy.

SECTION II

SPECIFIC OPTIONS

NATIONAL DEFENSE

This category presents 23 options to limit spending for national defense. The first 11 alternatives offer lower spending levels by reducing the rate of growth in procurement programs for major systems, such as the MX missile, F-15 aircraft, Bradley fighting vehicle, and amphibious ships. Savings would be achieved either by cancelling systems, as in DEF-01 and DEF-08, or by slowing the rate of procurement, as in DEF-04 and DEF-09.

Options DEF-12 through DEF-15 consider limits on spending in other military investment accounts. Over the next five years, the Administration plans to spend large amounts in areas such as research and development and military construction. Options discussed here would achieve savings by reducing the rate of growth in these accounts.

Limits on growth in the military forces and on further improvements in readiness are discussed in DEF-16, DEF-17, and DEF-18. Although limiting growth in these areas would provide no savings in the first year, all of these options would produce substantial savings once the options were fully implemented.

Finally, DEF-19 through DEF-23 offer savings by limiting the growth in pay and benefits for military personnel. These include alternatives to cost-of-living adjustments for retirees (DEF-19), and to slow pay increases for active-duty personnel (DEF-23). DEF-21 and DEF-22 are concerned with the military health-care system.

The estimates of savings from all options were made relative to the Administration's proposed budget (when program details were available), using CBO current economic assumptions. In most cases, savings are rounded to the nearest 100 million dollars, and are given in budget authority rather than outlays.

DEF-01 CANCEL THE MX

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings a/
Budget Authority	4,100	3,300	2,600	1,600	70	11,670
Outlays	1,170	2,270	2,600	2,380	1,730	10,150

a. Excludes $1.5 billion of unobligated prior-year appropriations for procurement.

The MX missile is a land-based intercontinental ballistic missile (ICBM), which can deliver 10 high-yield nuclear warheads. Weighing nearly 100 tons, the MX would be the largest, most accurate ballistic missile in the U.S. arsenal if it were deployed. Terminating the program would save $11.7 billion in budget authority over five years (including $4.1 billion in 1986), compared with the Administration's plan.

For more than two years, the Administration studied alternative MX basing modes, searching for one that both would be politically acceptable and also could survive a Soviet first strike. In April 1983, the President endorsed the recommendations to modernize the ICBM force prepared by the Scowcroft Commission. One Scowcroft recommendation called for prompt deployment of 100 MX missiles in existing Minuteman silos. Although this basing plan would leave the MX just as vulnerable to Soviet attack as the current ICBMs are, the Administration believed that the deployment of the new missiles would redress some of the asserted Soviet advantage in ICBM capability. Furthermore, the Administration hoped to demonstrate U.S. commitment to strategic force modernization and to provide an incentive for the Soviet Union to negotiate an arms control agreement.

The Administration also endorsed another Scowcroft recommendation to develop and deploy in the 1990s a small, single-warhead ICBM suitable for mobile basing. Because one-warhead ICBMs would present less valuable targets, they could provide greater nuclear stability in a crisis.

In 1984 the Congress approved both the MX program and the small ICBM. The Congress, however, limited procurement of the MX to 21 operational missiles, and linked continued MX deployment to the development and deployment of the small ICBM by 1992. The 1985 appropriation act financed 21 additional missiles, but the funds cannot be obligated until both Houses enact joint resolutions approving the expenditures.

The MX program could be cancelled, retaining the 21 missiles already bought, perhaps as space boosters. This alternative would rely on the existing force of 1,000 Minuteman missiles to supply the land-based part of the three strategic forces (including sea- and air-launched missiles) until the early 1990s when deployment of the small mobile missile force is planned. It would also rely on the rest of the substantial strategic modernization program to enhance deterrence and induce the Soviet Union to conclude an arms control agreement. The deployment of 100 MX missiles in existing silos would contribute little to total U.S. strategic capability, according to most measures.

DEF-02 COMBINE CFM-56 TANKER RE-ENGINING WITH CHEAPER ALTERNATIVE

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	-90	20	0	1,000	1,700	2,630
Outlays	-80	-90	-50	100	700	580

The Air Force maintains a fleet of 615 specialized tanker aircraft to refuel other aircraft in flight. These tankers extend the flying ranges of bombers for strategic nuclear missions and assist other military aircraft in conventional, nonnuclear contingencies. To prolong the working lives of these aging tanker aircraft and to meet increasing demand for aerial refueling, the Air Force has undertaken a multibillion dollar program to replace tanker engines with new, more powerful CFM-56 engines.

The CFM-56 program calls for building to a re-engining rate of 72 aircraft per year, in order to hold down unit costs and to meet the acute shortfall in tanker capacity. The program has, however, consistently been reduced because of budgetary constraints. Since 1981 the Congress has combined CFM-56 re-engining with a second re-engining program that uses salvaged and refurbished JT-3D engines from Boeing 707 aircraft retired from commercial service. Although the JT-3D does not match all the performance characteristics of the CFM-56, it is substantially better than the current tanker engine, and much cheaper to buy than the CFM-56--about $5.0 million a plane, instead of $20.0 million for the CFM-56.

Continuing a mixed program would combine annual re-engining of 36 aircraft with the CFM-56 and 36 aircraft with the JT-3D. Such a program could save $2.6 billion in budget authority through 1990, compared to the original Air Force program, and would provide 72 re-engined planes a year. Because JT-3D re-enginings take less time, this option would also provide more capable tankers in the next few years when the shortfall might be largest. JT-3D re-enginings are constrained by the supply of donor Boeing 707 aircraft, and this option would use about 160 of the roughly 400-500 aircraft now operating.

The JT-3D engine is noisier than the CFM-56, which would be a disadvantage near cities. Moreover, a mixed program could make logistics management more difficult. To date, the JT-3D program has been used only for tankers in the Air National Guard and Air Force Reserves. Although the age and varied histories of the JT-3D engines could make some of them difficult to maintain in the active force, the Guard and Reserve have not had serious problems with their JT-3Ds. Furthermore, the active forces already have experience with JT-3D type engines on other aircraft, including some B-52 bombers currently in the force.

DEF-03 AMEND THE ADMINISTRATION'S AIRLIFT PLAN

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	500	900	2,700	2,500	4,000	10,600
Outlays	270	560	1,150	1,920	2,280	6,180

The C-17 is a new, large military transport aircraft that is designed to fly long distances carrying large heavy loads, such as tanks and infantry fighting vehicles, and to land on relatively short airfields. These features would allow the aircraft to move troops and equipment from the United States to forward battle locations quickly, something that the Air Force does not believe is possible with the transports now in the forces. Partly because of this ability, the C-17 will be expensive. The Air Force plans to procure 210 of these planes, beginning in 1988, at a cost of about $125 million each in 1986 dollars. Cancelling this procurement would save $500 million in budget authority in 1986 and $10.6 billion over the next five years, compared with the Administration's plan. (These savings assume that current plans for expanding sealift are adequate to meet lift requirements even with the cancellation of the C-17.)

In order to deploy U.S. forces anywhere in the world in a relatively short time, the United States must be able to move heavy cargoes over long distances--that is, provide "strategic" airlift. According to the Department of Defense, U.S. forces today do not have enough aircraft to provide the airlift that would be needed early in a conflict between the United States and the Soviet Union. This is true even though the Congress agreed in 1982 to increase airlift capacity by procuring an additional 44 KC-10 and 50 C-5 aircraft. Even with the addition of these planes, available aircraft will fulfill only 73 percent of the DoD airlift objective.

Strategic lift can also be provided by ships. Although ships are slower--taking as long as 30 days to begin delivering cargo from the United States to Southwest Asia--both the Administration and the Congress have recently renewed their interest in sealift. Since 1982 the number of cargo ships in the U.S. Ready Reserve Force has increased from 27 to 65 through the acquisition of commercial ships. Some of these ships can sustain speeds of 26 knots while carrying as much as 11,000 tons of military equipment--equivalent to nearly 230 C-17 aircraft loads.

This option proposes to cancel the development and procurement of the C-17 aircraft, while continuing to invest in additional sealift. Current transport aircraft, together with the KC-10s and C-5s already approved, could provide sufficient airlift for the most likely contingencies. Only in the early weeks of a war involving the Soviet Union would the current airlift fleet be unable to meet the level deemed necessary by DoD. Moreover, some of the disadvantages of sealift in the early weeks of a war could be offset if loaded cargo ships began to deploy before hostilities actually commenced. Also, the Army, the principal user of airlift, is reorganizing some of its existing divisions so that they will require fewer aircraft to transport their equipment.

Cancelling the C-17 is not, however, without its disadvantages. Some risk is associated with not having more aircraft in the event of a conflict with the Soviet Union. In addition to taking longer, sealift might not always be able to deliver cargo where it is needed. Moreover, the adequacy of the current C-130 fleet, smaller aircraft designed to move cargo within a wartime theater, has been questioned. The C-17 is designed to assist with this intratheater airlift and would end fears that intratheater assets are insufficient. Finally, much of the current airlift fleet is aging. The C-141s and C-130s bought in the 1960s are reaching the end of their useful lives and, under current operating tempos, many will have to be replaced by the end of the 1990s. Thus some of the savings from this option might eventually have to be devoted to replacing these aircraft.

Savings associated with this alternative, however, are considerable. Moreover, savings would continue in the years beyond 1990, and even replacement of aging C-130 and C-141 aircraft in the 1990s should not consume all of them.

DEF-04 REDUCE CONSTRUCTION OF NEW SUBMARINES AND LSDs WHILE EXTENDING THE SERVICE LIFE OF EXISTING SHIPS

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	1,000	1,000	1,200	1,200	1,300	5,700
Outlays	60	200	400	610	840	2,110

Recent public debate on plans to enlarge the Navy has emphasized the need for new ship construction, but equally important are extending the service life and modernizing the combat systems for existing ships. Although Navy planners prefer to procure new ships, the expedient of making older ships last longer has often been used in the past and figures prominently in current plans for a "600-ship Navy." Selectively extending the service life of some submarines and amphibious landing ships (LSDs) could reduce shipbuilding budget authority by more than $1 billion annually without significantly affecting ship force levels. Cumulative five-year savings would be $5.7 billion. Obviously, though, such a course would affect the pace of fleet modernization.

From 1986 through 1990, the Navy plans to retire about 15 attack submarines (11 nuclear-powered and 4 diesel-electric), and to request funds to build 20 nuclear-powered SSN-688 class attack submarines and one new-design SSN. The average cost of each new SSN-688 class submarine will be about $720 million in fiscal year 1986 dollars, while the first SSN of new design will cost over $2 billion (later ships would cost less). Holding procurement of SSNs at the 1984 level of three per year, rather than four, and extending the service life of an offsetting number of older submarines would save $3.9 billion in procurement costs over the five years.

Similarly, the Navy plans to retire the four remaining Thomaston class LSDs from 1985 through 1990, and replace them with new LSD/LPDs (Amphibious Transport Dock) at the rate of two per year. Slowing construction of new LSD/LPDs to one per year and extending the operating life of some Thomaston class LSDs would save $1.8 billion over five years.

Any reduction in the shipbuilding program would diminish the capability of the force and would be offset only partially by extending the service life of older ships. The older submarines and LSDs mentioned above will have been in service about 25 to 30 years at their currently scheduled retirements. Nevertheless, the older submarines, though less capable than the new SSN-688s, can still perform a broad range of useful missions. Being relatively uncomplicated naval ships, the older LSDs suffer only from age, not technological obsolescence.

DEF-05 REDUCE THE RATE OF PROCUREMENT OF PATRIOT MISSILES

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	70	150	230	230	230	910
Outlays	10	50	120	180	220	580

The Patriot is the Army's new high- and medium-altitude air defense system that can engage several enemy aircraft simultaneously. Designed to replace the Nike Hercules and Hawk missile systems, a Patriot firing unit consists of a radar set, an engagement control station, and eight launchers, each with four missiles. In its seventh year of production, the Patriot successfully completed its third operational test during 1984.

Several operational problems were encountered during testing in 1983. In response, the Army postponed fielding the system and delayed achieving initial operational capability by about nine months. Because of these testing problems, the Administration reduced its 1985 request from 585 to 445 missiles in its May 1984 budget revision. Subsequently, the Congress appropriated funds for 440 missiles. In its report accompanying the fiscal year 1985 appropriation bill, the Senate directed the Army not to spend any funds for increased production until specifically justified to the Congress.

For 1986, the Administration is requesting $1.1 billion to purchase 12 firing units and 585 missiles. Over the four years from 1987 through 1990, the Army plans to spend about $4 billion to procure 36 firing units and more than 3,100 missiles.

This option would reduce the Administration's request and only 480 missiles would be purchased in each year through 1990, an amount consistent with the present minimum economic production rate based on current facilities. This option would extend the Army's present procurement plans for missiles by four years. As a result, unit costs would rise for the U.S. Army and possibly for the missiles that West Germany and the Netherlands plan to buy. This price increase might cause these foreign governments to reduce the number of missiles they purchase. Nonetheless, savings from this option would yield $70 million in 1986 in budget authority and $910 million through 1990.

DEF-06 CANCEL OR REDUCE PROCUREMENT OF THE F-15

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Freeze Annual Procurement at 36						
Budget Authority	300	300	700	800	800	2,900
Outlays	40	180	320	520	660	1,720
Cancel the F-15						
Budget Authority	2,500	2,500	2,900	3,100	2,900	13,900
Outlays	430	1,420	2,070	2,500	2,800	9,220

The F-15 is the Air Force's premier fighter, capable of operating during day or night and in inclement weather. Its long-range radar and medium-range missile enable the F-15 to attack enemy aircraft before they can detect and attack it. Because of the F-15's expense, however, the Air Force developed the less capable but cheaper F-16 to fulfill its total force requirements. The Congress cut F-15 procurement from 48 to 36 in 1984 and from 48 to 42 in 1985. DoD proposes to buy 48 in 1986 and increase the number to 60 per year by 1988.

Freeze Annual Procurement at 36. This option would save $300 million in 1986 in budget authority and $2.9 billion over the next five years. Current Air Force plans entail procuring more F-15s and F-16s, in part to replace older F-4s, most of which will reach their usual service life of 20 years by the late 1980s. By retaining the F-4s until they are 21 years old, the Air Force could still meet its goals to enlarge its tactical (that is, intratheater) force. Thus the savings from this option would come at the expense of keeping older, less capable aircraft for a slightly longer period.

Cancel the F-15. Alternatively, further procurement of the F-15 could be cancelled. This option would save $2.5 billion in budget authority in 1986 and $13.9 billion over the five-year period. Without offsetting increases in F-16 purchases, however, the Air Force would be unable to expand its structure unless F-4s were kept until they were 26 years old. Cancellation would also reduce total aircraft production capability and would foreclose the option of procuring the F-15E, an improved version of the F-15 that the Air Force plans to buy for its ground attack mission.

The effects of either option could be partially offset by increasing F-16 production, which would, however, produce substantially smaller savings. Regardless of numbers, the F-16 is less capable than the F-15 for some important missions, especially deep penetration.

DEF-07 CANCEL THE LANTIRN PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	500	900	700	700	700	3,500
Outlays	80	330	600	680	690	2,380

Low Altitude Navigation and Targeting Infra-Red System for Night (LANTIRN) is designed to aid pilots of single-seat aircraft in searching out and destroying surface targets while flying at low altitudes in poor visibility. The system identifies potential targets through infrared radiation and controls the flight of an air-to-surface missile that homes-in on the radiation source. Some critics in DoD feel that LANTIRN probably would not be effective for this primary purpose. Terminating the program would save an estimated $500 million in budget authority in 1986 and $3.5 billion over the next five years.

Several U.S. aircraft are scheduled to use the LANTIRN systems: the F-16, the A-10, and an improved version of the F-15. The Air Force plans to procure 720 LANTIRN units, all of which are scheduled to be purchased by 1991. The DoD argues that, in the event of a European conflict, LANTIRN would be needed to counter the large threat from enemy armored vehicles.

Since LANTIRN entered full-scale development in 1979, it has experienced problems. First, its unit cost grew rapidly from $3.0 million in 1981 to $5.3 million by the end of 1983. Second, the automatic target recognizer--a central part of the system--has been removed from full-scale development; the Defense Science Board has reported that it is unlikely that this feature can be developed soon. And finally, the system has experienced production problems and was six months behind schedule by 1984. The Congress expressed concern about these problems in the 1985 budget debate. The House Armed Services Committee removed nearly all of the requested production funds, and the Senate Armed Services Committee deleted about half of them, suggesting that the Air Force consider cancellation of the program if it experiences any more cost growth.

If LANTIRN were cancelled, alternative navigation systems could be pursued. One candidate might be the F/A-18 forward-looking infrared

(FLIR) pod. This would represent a return to the original intent of the LANTIRN program but would not provide the same low altitude night navigation capability designed into LANTIRN. It would eliminate the trouble-prone automatic target recognition, however. Those costs would reduce the savings shown above.

DEF-08 CANCEL THE ARMY HELICOPTER IMPROVEMENT PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings a/
Budget Authority	300	300	400	400	400	1,800
Outlays	30	150	270	360	400	1,210

a. Excludes $100 million of unobligated prior-year appropriations for procurement.

The Army Helicopter Improvement Program (AHIP) is an interim modification program to extend the usefulness of existing OH58 scout helicopters. The Army also plans to procure a new light helicopter (the LHX) in the 1990s to satisfy, among other things, the scout helicopter mission. Cancelling the AHIP and waiting instead for the new helicopter could save an estimated $300 million in budget authority in 1986 and $1.8 billion over the next five years.

Scout helicopters carry no weapons; their primary purpose is to identify and designate targets for attack helicopters and artillery. The AHIP will improve the identification and designation of targets at nighttime (by using infrared sensors and laser range finders) and will increase the operational capability of the helicopter in the hot climate of Southwest Asia (by upgrading the engine and transmission and by adding a four-blade main rotor). The AHIP program would improve 56 scout helicopters in 1986 and modify a total of 510 by 1990. Concurrently the Army is preparing for full-scale development of a new fleet of helicopters which will be better equipped to serve as scouts.

Cancellation of AHIP would require the Army to rely upon the current OH58 scout helicopter until the new fleet of scout helicopters is deployed in the early 1990s. Some of the target identification and designation mission could be provided by the Ground Laser Locator Designator (designed for the artillery) now in production or by the attack helicopter itself. A small portion of the savings might be devoted to minor "safety-of-flight" modifications, although those costs would reduce the savings shown above.

DEF-09 LIMIT PRODUCTION OF THE M2 BRADLEY FIGHTING VEHICLE

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	300	500	500	470	-100	1,670
Outlays	5	150	340	430	450	1,375

The Army's M2 Bradley fighting vehicle is designed to accompany and keep pace with the M1 Abrams tank on the battlefield. The M2 can carry infantry personnel while also providing firepower from the TOW antitank missile and a 25mm automatic cannon. The M2 offers substantial improvement over the old M113, which provided armored protection for infantry squads but had little offensive striking power of its own. Holding production to 540 vehicles a year would save $300 million in budget authority in 1986 and $1.7 billion over the next five years, compared to the Administration's plans.

The M2 is assessed to be superior to any fighting vehicle available to Warsaw Pact forces. It has been criticized in recent years, however, for several reasons: for its great expense ($1.7 million each in fiscal year 1986 dollars, with Army plans to buy nearly 7,000 units by the end of 1990); on technical grounds (some critics charge that it does not offer adequate ballistic protection when hit by modern munitions); and for its poor amphibious capabilities.

The M2 is well into procurement. From 1982 through 1984, 600 vehicles were produced annually, and in 1985 the Congress appropriated funds for 655 vehicles. The Department of Defense proposes to buy 716 vehicles in 1986, and plans to increase production to a sustained rate of 900 annually by 1989.

M2 production could be limited to 540 vehicles a year--the current minimum economic rate with existing facilities. This slowdown would mean some units would not receive the M2 as quickly. It would also mean higher unit costs than would occur at greater production rates. Because of their higher priority, however, units that are forward deployed in peace-time would still receive as many M2 vehicles even with a lower production rate. The slower rate could retain some of the deterrent effects of the Administration's more rapid acquisition program, if not its total warfighting capability.

DEF-10 CANCEL THE DIVISION AIR DEFENSE GUN

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings a/
Budget Authority	600	700	600	60	30	1,990
Outlays	50	320	520	570	340	1,800

a. Excludes $200 million of unobligated prior-year appropriations for procurement.

The Army's Division Air Defense Gun (DIVAD) is designed primarily to attack enemy helicopters and low-altitude aircraft that are within four kilometers of the DIVAD. It is also capable of attacking lightly armored vehicles and trucks. Mounted on a M48A5 tank chassis, this twin 40mm gun system relies on a sophisticated radar, similar to that of the F-16 aircraft. The system has a rapid-fire capability; after it identifies a target, DIVAD can position and fire its gun within 10 seconds. The DIVAD will replace the existing Vulcan 20mm gun system. Vulcan has an effective range of two kilometers, but, because it lacks sophisticated radar, has limited effectiveness at night and in bad weather when it cannot sight a target. Cancelling further DIVAD production would result in budget authority savings of $600 million in 1986, and a total of $2 billion over the next five years.

To date, the Army has funds to procure 263 systems and has received 31. The Administration is requesting about $600 million to purchase 117 DIVAD guns in 1986 and plans to procure 351 during the next three years.

Although the DIVAD offers potentially significant improvements over the Vulcan and has been in production since 1982, it has been plagued with production and performance problems during the past year. Specifically, production problems have caused the program to slip at least seven months, and limited operational tests to date have raised questions about the gun's capability. As a result, the Secretary of Defense delayed signing the contract covering fiscal year 1984 production, and directed the Army to complete further testing by the summer of 1985. In the fiscal year 1985 appropriation act, the Congress directed that no production funds be spent until completion of the operational tests and certification by DoD that DIVAD was the most cost-effective alternative for the Army.

One option is to cancel the DIVAD program, directing the Army to develop a more reliable system to defend against enemy aircraft. Because a new development program could not be completed until the 1990s, the Army would have to rely on the Vulcan air defense gun and the Stinger air defense missile or procure some other existing air defense system in the interim. DIVAD systems already procured could be deployed in Europe and in Korea to be used where appropriate by corps commanders; some could also be retained for training in the United States.

DEF-11 DELAY PROCUREMENT OF AQUILA REMOTELY PILOTED VEHICLE

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	150	270	280	250	160	1,110
Outlays	10	70	170	230	240	720

The Aquila Remotely Piloted Vehicle (RPV) is a small fixed-wing drone aircraft, primarily designed to perform aerial reconnaissance, target acquisition, and laser designation of targets to ranges of 45 kilometers beyond the forward battle area. It is launched from a rail assembly mounted on a five-ton truck chassis, and is recovered using a large net mounted on a separate five-ton truck chassis. The RPV's flight path is controlled either by line-of-sight communication through digital control or by preprogramming the flight plan. By eliminating the procurement of the Aquila and maintaining the research and development efforts, this option would save $150 million in 1986 in budget authority and about $1.1 billion over the next five years, assuming procurement of any RPV system is delayed that long.

While the Aquila would be the first RPV fielded by the Army, the Army is deploying other systems that can perform roughly the same tasks although not necessarily to the same degree as the design specifications of Aquila. Indeed, by 1990 the Army plans to field more than 1,000 Ground Locator Laser Designators (known as GLLDs) and more than 1,000 helicopters capable of target reconnaissance, identification, and laser designation. Moreover, only two Army munitions--the Copperhead (launched by 155mm howitzers with ranges of roughly 18-24 kilometers) and the Hellfire missile (launched by attack helicopters)--can engage targets designated by laser.

The Aquila also would decrease the strategic and tactical mobility of Army units. Only the large C-5 aircraft could carry it assembled so only a few planes would be available to transport the Aquila quickly to a combat zone. Deployment in the more numerous but smaller C-141 or C-130 aircraft could be accomplished only after a major, time-consuming disassembly. Additionally, the Army does not plan to acquire many Aquilas for its operating units. Although it plans to purchase 548 air vehicles of all types, only 169 will be deployed to support 13 heavy divisions. The remaining 379 vehicles are earmarked for training, war reserve stocks, and to replace peacetime losses. Moreover, the Army is considering alternative RPVs for its six light infantry divisions, primarily because Aquila is too heavy and not easily deployed. Thus, the Army might field at least two different RPVs to satisfy the mobility requirements for the light infantry divisions. Finally, the Aquila would not replace any current equipment in the Army's inventory. About 1,000 personnel to support the RPV system would have to be added to the current structure for the target acquisition batteries that would be located at corps level.

The Administration is requesting $150 million to purchase eight Aquila air vehicles in 1986, and about $1.1 billion to procure 449 vehicles over the 1986-1990 period. Current plans envision attaining an initial operational capability during fiscal year 1989.

Until these various problems and plans are worked out, production of the Aquila could be delayed and the Army could continue to test and evaluate Aquila and alternative RPV systems such as the Israeli Mastiff, the Lear Siegler Skyeye, or the Canadian Sentinel. Indeed, the Army could join with the Canadians, West Germans, and French in evaluating the Sentinel. While this hovercraft RPV might not offer all the stability of a fixed-wing platform for target designation, it could provide enhanced tactical mobility and strategic deployability. Such an approach would delay the fielding of an RPV, however.

DEF-12 LIMIT SPENDING GROWTH FOR SUPPORTING PROCUREMENT

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Reduce Real Growth by 50 Percent						
Budget Authority	900	1,100	1,300	1,400	1,500	6,200
Outlays	230	560	890	1,120	1,280	4,080
Limit 1986 Spending to Real 1985 Level						
Budget Authority	1,700	5,900	8,600	10,000	10,800	37,000
Outlays	440	2,070	4,480	6,870	8,670	22,530

Most public debate over the defense budget revolves around large weapons systems, such as the B-1 bomber, MX missile, and M-1 tank. Acquisition of such weapons accounts for about 80 percent of total appropriations for procurement. The remaining 20 percent--labeled here as "supporting procurement"--is spent for vehicles, communications equipment, general purpose computers and office equipment, training devices, and the variety of other equipment required by the military services. These items support the operational needs of the services both in the field and in headquarters. In terms of mission importance, they range from items essential to military operations, such as trucks and communication gear, to items more related to peacetime activities, such as office computers.

Reduce Real Growth by 50 Percent. In 1985 the Congress limited the Administration's request for a 30 percent increase in supporting procurement accounts to nearly 17 percent in real terms. The Administration has requested a real increase of 8.7 percent in its 1986 budget. Growth could be limited to about one-half the real increase requested for 1986 and the accounts could be allowed to grow at the rate projected by the Administration in subsequent years. Relative to the Administration's plan, this reduction would save $0.9 billion in budget authority in 1986 and $6.2 billion over five years because of the lower base on which future growth would be calculated.

Because of the many items covered by these accounts, this report cannot specify the detailed changes needed to achieve the savings discussed above. Such cuts probably would slow or prevent further improvements in the stockpile of equipment needed to sustain a protracted war. Thus this option might be most consistent with the assumption of a shorter, intense conflict. Looked at another way, this option would spread the total planned real spending for supporting procurement over six years, compared to the five years planned by the Administration. This view might provide some guide to the risks inherent in the option. Increased reliance on competitive procurement, more realistic pricing, and tighter inventory control might achieve some of the savings without reductions in procurement.

Limit 1986 Spending to Real 1985 Level. Alternatively, real spending for supporting procurement could be frozen at the 1985 spending level for one year and allowed to grow at a 3 percent real rate in subsequent years. This would save $1.7 billion in budget authority in 1986 and $37 billion over the next five years, although it would not provide any increase in 1986 over the 1985 level of effort in the supporting procurement accounts. Rather it would maintain the 1985 level of effort for an additional year and then allow for modest growth. Although this alternative would intensify the effects of reduced procurement discussed above, the current condition of combat forces should not be affected.

DEF-13 LIMIT GROWTH IN DoD RESEARCH AND DEVELOPMENT

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Reduce Spending by 8 Percent						
Budget Authority	3,100	3,400	3,900	4,500	5,300	20,200
Outlays	1,600	2,850	3,440	4,000	4,640	16,530
Limit 1986 Spending to Real 1985 Level						
Budget Authority	6,300	6,800	10,600	14,100	20,800	58,600
Outlays	3,230	5,720	8,270	11,600	16,500	45,320

Research, Development, Test and Evaluation (RDT&E) funding for the Department of Defense pays for a wide range of activities: primary research, such as high energy physics or microbiology; applied research, such as ceramic or construction engineering; engineering development to put weapons systems into production; and testing programs for potential weapons or experimental designs. These funds also finance the operation of government laboratories and the research of universities, private laboratories, and large defense contractors.

The adequacy of RDT&E funding and the potentially adverse effects on research necessitated by lower than planned spending levels are difficult to measure. Much of the research funding is spent to explore new technologies, only some of which lead to advanced research and development. Although real increases in research funds should allow continued research in new areas, more stringent spending levels might require greater scrutiny of new research proposals and harder choices about the continued funding and rate of funding for ongoing programs. At some point, tighter research budgets would result in a narrowing of the U.S. technological advantage over the Soviet Union.

Reduce Spending by 8 Percent. During the past three years, the Congress has reduced the Administration's requests for RDT&E funding by 7 percent to 8 percent. Some of the reductions were directed to specific programs (for example, the Joint Tactical Missile System and Strategic Defense

Initiative), while others were undistributed or were presumed to result from improved efficiencies in DoD laboratories and contracts. In fact, the President's Private Sector Survey on Cost Control (PPSSCC) reported that efficiencies in R&D efforts could be achieved by improving laboratory operations and general R&D management. The R&D funds could be reduced by 8 percent again this year and allowed to grow at the rate projected by the Administration in subsequent years. This would result in budget authority savings of $3.1 billion in 1986 and of $20.2 billion over the next five years, compared with the Administration's program. Still this would permit a real increase in 1986 of over 10 percent and would fund RDT&E at about 11 percent of the entire defense budget.

Because such a large number of programs exist in this area, this report cannot specify which programs would be affected by this slowdown. Last year, for example, the Congress made detailed changes to over 300 different RDT&E programs. The Strategic Defense Initiative (discussed in DEF-14) would probably be affected by any major slowdown in RDT&E funding. Under this option, six years would be required to accomplish the same level of real spending as the Administration planned in five years. This delay might provide a guide to any risks inherent in such a slowdown.

Limit 1986 Spending to Real 1985 Level. Even greater savings could be achieved if RDT&E spending was restricted in real terms to the 1985 spending level for one year and allowed to grow at a 3 percent real rate in subsequent years. This would save $6.3 billion in budget authority in 1986 and a total of $58.6 billion over the next five years, while retaining the same level of effort previously supported by the Congress before allowing for continued growth. Savings of this magnitude, however, could not be achieved without further restructuring the R&D plan proposed by the Administration. Some low priority programs might have to be deleted to allow growth in programs that prove more promising or enjoy a higher priority.

DEF-14 SLOW OR LIMIT GROWTH IN THE STRATEGIC DEFENSE INITIATIVE

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Spread Spending over Six Years						
Budget Authority	900	1,200	1,500	1,800	2,200	7,600
Outlays	430	940	1,290	1,620	1,960	6,240
Reinstate Former Spending Level						
Budget Authority	2,000	2,900	3,700	4,700	5,800	19,100
Outlays	960	2,200	3,120	4,070	5,070	15,420

On March 23, 1983, President Reagan called for the United States to achieve the means to render nuclear weapons "impotent and obsolete" by developing defenses that could destroy an enemy's nuclear weapons before they exploded on American soil. The research and development plan resulting from this mandate--known as the Strategic Defense Initiative (SDI)--calls for devoting about $33 billion through 1990 to study applicable technologies and systems concepts, ranging from space-based lasers and particle beam weapons to more conventional antiballistic missile (ABM) systems.

The planned budget calls for a steep rate of real growth in SDI funding: 156 percent from 1985 to 1986, and increasing by an average of 19 percent annually through 1990. With this growth, the SDI will consume a greatly increasing share of Department of Defense research and development resources. In 1985, the first year of the SDI program, the SDI represented about 5 percent of the overall Research, Development, Test and Evaluation (RDT&E) budget. By 1990 the SDI would take up 17 percent, or about one-sixth, of the total DoD research budget. In view of this increase, the Congress has expressed concern about the efficient use of these fast-growing funds, as well as the impact SDI funding might have on other important research and development programs. Some members of the Congress have also expressed concern that the SDI primarily depends on technological breakthroughs as yet unrealized and that pressure to proceed beyond research could lead to abrogation of the ABM treaty, thus fueling an arms race in space with the Soviets.

Spread Spending over Six Years. Some of these concerns could be addressed by spreading the real spending proposal for the next five years over six years. Under this plan, the SDI would still consume about 10 percent of the DoD research budget by 1990. Remaining funding should still allow intensive evaluation of the feasibility of new strategic defense technologies. Full-scale development and deployment decisions would continue to be pursued in the 1990s, although they might be delayed by a year or so. The near-term reductions would save $0.9 billion in budget authority in 1986 and $7.6 billion over the next five years. This slowdown would allow more time to develop this large program efficiently and to debate fully the technical and arms control issues involved in the efforts.

Reinstate Former Spending Level. Alternatively, spending could be limited to the amount that was planned before the introduction of the SDI. Officials in the SDI program have indicated that together DoD and the Department of Energy planned to spend about $13 billion through 1989 on research for strategic defense before the formal initiative and that the SDI, therefore, represents about a doubling of the previous level. This alternative provides spending at the pre-SDI level through 1989 and grows at the rate currently proposed by the Administration from 1989 to 1990. This would be consistent with maintaining a lower level of research primarily as a hedge against a Soviet defense breakout and not as a program aimed at development and de-ployment decisions. Using the benchmark of previously planned funding, savings could be about $2 billion in budget authority in 1986 and $19.1 billion through 1990.

DEF-15 LIMIT SPENDING GROWTH FOR MILITARY CONSTRUCTION

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Limit Spending Growth to 6 Percent						
Budget Authority	1,000	1,200	1,500	1,700	2,000	7,400
Outlays	100	500	900	1,200	1,500	4,200
Limit 1986 Spending to Real 1985 Level						
Budget Authority	1,300	2,800	4,000	5,400	6,600	20,100
Outlays	200	900	1,900	3,100	4,300	10,400

Military construction funding for the Department of Defense pays for a wide range of activities: combat-related construction, such as ammunition storage facilities and aircraft and weapons maintenance facilities; morale- and welfare-related construction, such as indoor swimming pools and child care centers; and living accommodations, such as unaccompanied personnel housing and barracks. These funds also pay for acquisition of land for military use and for modifications to existing facilities.

Limit Spending Growth to 6 Percent. Military construction funding has increased by an average of 6 percent in real terms since 1983. Despite the increases in military construction provided by the Congress, the average for the past three years was still over 20 percent less than the Administration requested. In 1986 DoD has asked for $7.1 billion for military construction, a real increase over the 1985 level of 23 percent. If this request was limited to the average real growth appropriated since 1983 and allowed to grow at the same rate proposed by the Administration in subsequent years, this option would save $1 billion in budget authority in 1986 and $7.4 billion over the next five years.

Potentially adverse effects of continuing to limit the growth in military construction are difficult to assess because of the large number of projects. Some projects might take longer to complete, or those with low priority could even be dropped. One measure of the effects of such limits would be the time required to complete the Administration's programs; with the limits, it would require about six years to complete the projects the

Administration's request would finish in five years. On the other hand, imposing limits on growth in construction funds would offer some advantages. The DoD might be encouraged to seek more efficient and consequently less costly means of completing the same number of projects, thus retaining much of the construction provided by its proposed spending level.

Limit 1986 Spending to Real 1985 Level. As an alternative, military construction funding could be restricted, in real terms, to the 1985 level in 1986 and allowed to grow at a 3 percent real rate in subsequent years. This would save $1.3 billion in budget authority in 1986 and a total of $20.1 billion over the next five years. The effects of such a freeze on spending would be more far-reaching. Some planned military construction programs would probably be cancelled or postponed indefinitely. New projects, such as military construction programs at Ft. Drum, New York, and in Alaska to support the Army's new divisions, might have to be cancelled or reduced in scope unless other projects were reduced to make room for them.

DEF-16 SLOW INCREASES IN THE TACTICAL AIR FORCE

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Savings in Total Federal Budget a/						
Budget Authority	0	200	500	900	1,300	2,900
Outlays	0	100	340	630	970	2,040
Savings in Defense Budget a/						
Budget Authority	0	200	500	900	1,300	2,900
Outlays	0	110	380	710	1,070	2,270

a. Savings in the federal and DoD budgets are different because of the effects of accrual accounting applied to retirement costs of military personnel. For a discussion of accrual accounting, see DEF-19.

The Administration announced in 1981 that it intended to increase the Air Force tactical fighter force to 40 air wings by 1986, with a further increase to 44 wings by the early 1990s. (A typical wing consists of 72 combat aircraft with 28 backup aircraft for training and maintenance.) The pressure to finance higher-priority programs has led the Air Force to postpone these increases, however, in favor of financing modernization (see DEF-06). Current plans are to field 40 wings by 1991, with no publicly announced expansion planned beyond that. Additionally, the Congress has expressed some reservations about the 40-wing force. The Senate Appropriations Committee, in its 1985 report, indicated that it supported modernization but not necessarily an expansion of the existing force.

The Air Force believes that the increasing quality and quantity of Soviet aircraft pose a growing threat. Modernization of U.S. forces without force expansion, therefore, might not be sufficient to maintain the current balance between U.S. and Soviet tactical air forces, while simultaneously meeting the expanding global commitments desired by the Administration.

If the force expansion planned by the Air Force were delayed beyond the next five years, the manpower and operation support requirements would be decreased over this period. Any risks to national security caused by this delay are risks the Air Force has been willing to take in recent years as it delayed force expansion in favor of buying modern aircraft for existing wings. Although no savings in budget authority would be realized in 1986 by slowing the expansion, $2.9 billion could be saved by 1990, compared with the Administration plan. (Outlay savings are greater in the defense budget than in the total budget because the former counts savings for future retirees.) Moreover, a decision to delay expansion now would allow for orderly planning of aircraft purchases during the next several years.

DEF-17 PLACE THREE CARRIER BATTLE GROUPS IN RESERVE

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	0	70	200	300	400	970
Outlays	0	60	180	300	380	920
Savings in Defense Budget a/						
Budget Authority	0	70	200	300	400	970
Outlays	0	50	150	250	320	770

a. Savings in the federal and DoD budgets are different because of the effects of accrual accounting applied to retirement costs of military personnel. For a discussion of accrual accounting, see DEF-19.

As a major feature of its defense program, the Administration plans to increase the number of aircraft carriers in the Navy's active fleet from 13 to 15. This would also necessitate a commensurate increase in the number of carrier air wings, escort ships, and support ships. Some, however, believe that a force of 15 carriers is not required and that 12 would be adequate. A middle ground between these two positions would be to maintain a force of 12 carriers in the active fleet and assign three carriers along with their associated air wings, escorts--about six per carrier--and support ships to a special category of the Naval Reserve Force. Although no savings in budget authority would be realized in 1986 by adopting this option, nearly $1 billion could be saved by 1990, compared to the Administration plan.

These reserve ships would be manned with reduced crews of active-duty personnel, about 50 percent or less of the ships' normal complement, to perform basic maintenance. The remainder of the crews would be in the reserves. These ships would not get under way unless mobilized, and assignment to one would count as shore duty in sea/shore rotation. The reserves in this option would be placed in a special, nondrilling status. To ensure their proficiency, these reserves would be assigned to the carrier group only for a short period--probably a few years--after they left active duty. Arguably, their skills would not have atrophied greatly in that short period. Unlike inactive reserve (mothball) ships, these ships would be given periodic overhauls and updated with modern equipment.

This option would also change the Navy's current plans for 14 active air wings and two reserve wings to 12 active wings and, eventually, three reserve wings. (An air wing consists of about 90 aircraft per carrier plus associated equipment and personnel.) Reserve air wings would be manned at current levels, which would permit the substantial peacetime training necessary to maintain flying skills. Carrier training for the reserve wings would be conducted on active-duty ships, as is done now. This option would not alter current procurement plans, however, since both the ships and wings in the active and reserve forces would be modernized.

This approach might require curtailment of current peacetime deployment commitments. The four carriers normally maintained on overseas deployment have recently been increased to five. Having three carriers in the active fleet for each one on deployment allows the crews to spend more time in port and thus promotes retention. With fewer carriers in the active fleet, the Navy would have to risk harming retention or, alternatively, curtail regular peacetime deployments to four carriers. It is possible, however, that the effects of such a curtailment in peacetime could be offset by use of other vessels--like battleships or cruisers--in place of the carriers. Alternatively, these effects could be offset by "surge" deployments. Rather than maintaining continuous overseas deployments in peacetime, the United States could send carriers to some regions only in the event of an increase in tension. Such a surge strategy reduces the need for substantial peacetime forces, and the shift in visibility caused by the surge might also increase the deterrent effect of the carriers.

Such an alternative would also reduce the number of aircraft carriers available early in a war. It would probably require from two to three months for the reserve carriers to be activated fully. During those early months of conflict, the Administration's plan for 15 carriers in the active fleet would provide greater capability. The number of carriers that would be needed in some future conflict is something that cannot be known until a conflict actually occurs, but this option would involve some increased risk in the early days of a major war. On the other hand, it would certainly take less time to activate these reserve carriers than it would to reactivate a vessel in the mothball fleet and much less time than the eight years or so required to build a new carrier and associated escorts.

DEF-18 LIMIT OPERATION AND MAINTENANCE SPENDING

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Reduce Spending by 3 Percent						
Budget Authority	2,500	2,900	3,300	3,500	3,800	16,000
Outlays	2,000	2,800	3,200	3,500	3,700	15,200
Limit 1986 Spending to Real 1985 Level						
Budget Authority	3,600	12,200	19,600	21,500	23,500	80,400
Outlays	2,900	10,400	17,800	20,800	22,800	74,700

About 27 percent of 1985 defense appropriations supports the operation and maintenance (O&M) of existing plants and equipment. Part of this account pays for civilian workers. The rest purchases goods and services for maintenance of existing equipment, training, fuel and spare parts, base operations, and many other things. Spending for these activities is commonly referred to as "readiness" spending since it contributes directly to the day-to-day capability of the military forces.

Since 1981 O&M spending has increased about 26 percent in real terms. Higher funding has provided increased readiness according to some measures but not others. For example, the percentage of scheduled depot maintenance in backlog status declined from 15 percent to 11 percent while the percentage of units reporting improved training readiness increased by 25 percent during the period. Other key measures, however, such as battalion training days, crew flying hours, and equipment mission capable rates generally show only slight improvement.

Current plans call for O&M funding to increase over 38 percent in real terms during the next five years. While detailed data are not available, growth is probably higher for O&M purchases rather than civilian personnel for whom the Administration has proposed a 5 percent pay reduction in 1986. Presumably this higher funding is intended to pay for operating increased numbers of forces and to place current forces at a higher state of combat readiness and effectiveness.

The planned additions to military forces during this period, however, do not seem to require substantial increases in O&M. Based on five-year force structure and modernization plans submitted by DoD in February 1984, CBO projects an increase in tactical aircraft of 11 percent in the Air Force and 8 percent in the Navy. Strategic aircraft will remain relatively constant. Navy battle force ships will increase by 11 percent while total Army forces, although reorganized, remain virtually unchanged. Active-duty personnel will increase by only 4 percent while Selected Reserve personnel will increase by 11 percent. CBO estimates that these overall changes will require about 8.0 percent real increase in O&M spending over the next five years, if the present spending patterns are maintained.

Beyond the 8.0 percent level, increases in O&M would presumably be spent for activities to improve current readiness levels. If force readiness improvements, although modest by most measures, were deemed sufficient, this could justify slowing further growth in O&M. In light of the need to control spending, future increases could also be limited if observers felt the relationship between O&M spending and readiness is highly uncertain.

Reduce Spending by 3 Percent. Perhaps for the above reasons, the Administration and the Congress have, during the past five years, reduced O&M appropriation requests from DoD by an average of 3 percent per year. A reduction of 3 percent in the Administration's 1986 O&M request, followed by the growth proposed by the Administration in subsequent years, would provide budget authority savings of $2.5 billion in 1986 and a total of $16 billion through 1990. The detailed changes needed to implement such a reduction can only be determined by extensive analysis of service budget details, which is beyond the scope of this report. In previous years, however, the Congress limited growth in O&M by such measures as reducing flying hours, postponing ship overhauls, and decommissioning ships earlier than scheduled.

Limit 1986 Spending to Real 1985 Level. Holding future O&M spending in real terms at the 1985 level for one year followed by 3 percent real growth in subsequent years would save $3.6 billion in budget authority in 1986 and a total of $80.4 billion over the next five years. In 1986, this might require a reduction in operating tempos relative to today's level in order to finance the operation of an expanded force. Maintenance of current operating tempos, however, might be possible even at this spending level if operating and maintenance efficiencies can be realized.

DEF-19 REDUCE COLAs FOR WORKING-AGE MILITARY RETIREES

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	0	4,070	4,510	4,900	5,300	18,780
Outlays	0	-30	280	550	820	1,620
Savings in Defense Budget						
Budget Authority	0	4,070	4,510	4,900	5,300	18,780
Outlays	0	4,060	4,510	4,900	5,300	18,770

The military retirement system provides benefits for about 1.4 million persons at a cost of $18 billion in 1986. Most military retirees are relatively young when they begin drawing their benefits; for example, in 1983 the average retirement age for nondisability active-duty service members was 43 years. In 1982 the Congress decided to provide half the regular cost-of-living adjustment (COLA)--as measured by the CPI--to nondisability retirees under age 62. This "half-COLA" applied only for fiscal years 1983, 1984, and 1985. The provision also applied only when half the normal COLA exceeded a minimum raise specified in the law. The Administration proposes to freeze federal retirement benefits--including those of military retirees--for 1986, but to make no permanent changes in military retirement and resume payment of full COLAs in 1987. Several changes are proposed to reduce the costs of civil service retirement, including higher retirement ages and substantial annuity reductions for early retirees.

One criticism of the limited half-COLA provision is that its burden on retirees depends on future rates of inflation. Because military members' decisions to remain in service are generally recognized to depend, at least in part, on the value of their retirement benefits, half-COLA thus introduces an element of uncertainty that could make it more difficult to retain experienced personnel. To eliminate this uncertainty while still realizing savings from reduced retirement benefits, COLAs for military retirees under age 62 could be set equal to some fixed amount less than changes in the CPI. For example, a "COLA-minus" rate of two percentage points might be adopted, thus providing military retirees with annual percentage adjustments of retired pay equal to two percentage points less than the percentage change in the CPI.

Enacting such a provision permanently would save an estimated $18.8 billion in the defense budget, but only $1.6 billion in total federal outlays, from 1986 through 1990. (The difference between defense and federal outlays is the result of accrual accounting for military retirement, as discussed below.) These savings are relative to the Administration's proposed budget, assuming that the statutory change to "COLA-minus" is enacted in fiscal year 1987 but that the Administration's proposed freeze applies in 1986.

Because most nondisability military retirees work in second careers for a number of years, proponents of this option contend that these retirees need inflation protection less than their older counterparts who are no longer in the labor force. Indeed, lower annuities for military retirees in their working years have been recommended by most of the nine major studies of the military retirement system completed since 1969.

Opponents argue that any reduction of future retirement benefits would induce premature separations and so reduce the size of the military career force (defined to include those with four or more years of service). CBO estimates that the plan for COLA minus two percentage points would decrease the career force by about 4 percent. If necessary, this modest reduction could be offset by other incentives, such as reenlistment bonuses in those skills in which retention of experienced people is most needed. This possible cost increase was not included in the above estimate but would not offset more than a small part of the total savings.

Savings in the defense budget would be larger than those in the federal budget as a whole because of the "accrual accounting" procedures enacted in 1983 and first implemented in the budget for 1985. Under these procedures, the accrual costs of future retirement liabilities, rather than actual current payments to retirees, appear as budget authority and outlays in the defense budget and budget authority in the total federal budget. Actual payments to retirees still determine federal outlays, however. Accrual accounting is designed to show the costs of future retirement in today's defense budget, so that retirement costs will be considered in decisions made today even though the actual expenditures will not occur for many years.

Under accrual accounting, the COLA-minus proposal--which would cause future retirement costs to drop sharply--would cause a large reduction in defense and total federal budget authority and in defense outlays. These reductions in budget authority correspond to the savings in retirement pay that the government eventually would realize under the COLA-minus proposal. But the outlays in the defense budget for the accrual costs are cancelled out elsewhere in the federal budget, so federal outlays continue to reflect actual payments to retirees. Since payments to retirees fall only gradually, total federal outlay savings over the next five years would be smaller than reductions in budget authority. Indeed, estimated outlays in the federal budget would actually increase in the first year because this option would cause changes in the overall composition of the military forces, as noted above, and thus would lead to changes in related military personnel costs. The savings in retirement outlays, when combined with these associated changes in personnel costs (pay and allowances, recruiting, and training) would produce net reductions in federal outlays after an initial increase in cost caused primarily by training costs for new personnel.

DEF-20 RESTORE PREVIOUS ENLISTED-OFFICER RATIOS

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	90	315	600	815	905	2,735
Outlays	60	220	425	575	640	1,920
Savings in Defense Budget a/						
Budget Authority	90	315	600	815	905	2,735
Outlays	90	310	600	810	900	2,710

a. Savings in the federal and DoD budgets are different because of the effects of accrual accounting applied to retirement costs of military personnel. For a discussion of accrual accounting, see DEF-19.

The ratio of enlisted personnel to officers in the armed forces could be increased, possibly with little loss of military effectiveness. Since its post-Vietnam peak in 1977, the ratio has declined from 6.5 enlisted personnel for every officer to about 6.0 per officer in 1984. (Since 1964, the ratio has declined from 6.8 to 6.0.) The sharpest decline has occurred in the Army; its ratio has fallen from 7.0 enlisted personnel per officer to 6.3 in 1984. The Department of Defense manpower projections imply that the overall ratio will remain constant at its new level through 1988.

This decline might be the result of changing military requirements. Some military missions, such as training, require fewer enlisted personnel per officer than other missions (general purpose combat forces, for example). But the decline in the overall ratio is not explained by shifts in major military missions. Nor does it appear that increases in the technical complexity of weapons systems justify having more officers relative to enlisted personnel. Indeed, the Army has been the slowest service to modernize its inventory of equipment, but the fastest to reduce its enlisted-officer ratio.

In principle, each of the services plans the mix of officers and enlisted personnel at a highly detailed level and then aggregates its plans to yield overall personnel totals. Apart from equipment modernization, this process might produce a declining enlisted-officer ratio as the result of considerations such as maintenance of a larger mobilization cadre or substitution of senior enlisted and officer supervisory personnel for junior enlisted forces. In the absence of specific explanations for the falling enlisted-officer ratio, however, the persistent tendency of the ratio to decline might suggest the need to impose aggregate limits. Such limits would also be consistent with announced Administration efforts to reduce the number of federal civilian personnel at middle and senior levels.

The services could recruit fewer officers while leaving their enlisted recruiting plans untouched. If, over the next three years, officer strengths were reduced by 14,700, then by 1988 the ratio would be about 6.25 enlisted personnel per officer. This limit would reverse about half the decline in the enlisted-officer ratio that occurred between 1977 and 1984. Such a policy would reduce manpower levels modestly in 1986. It would save $90 million in 1986 and a total of $2.7 billion in budget authority over the next five years, compared with the Administration's plans. In addition, such a limit might result in slower promotions within officer ranks and thus generate modest additional savings in pay and allowances beyond those estimated here. (The difference between savings in budget authority and savings in total federal outlays stems from accrual accounting for military retirement, as discussed in DEF-19.)

Savings would be considerably smaller, of course, if total military personnel were maintained at planned levels. In that event, the ratio of enlisted to officer personnel could be reduced by substituting enlisted personnel or lower-ranking warrant officers for commissioned officers.

DEF-21 INCREASE DEDUCTIBLES FOR MILITARY HOSPITAL CARE

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	65	65	65	65	65	325
Outlays	50	65	65	65	65	310

Besides caring for patients on active duty, military hospitals treat over one-half million inpatients each year who are retirees or dependents of retired or active-duty personnel. Most of these nonactive-duty patients pay a small fee. Dependents pay $7.10 a day (or $25 for their entire stay, whichever is higher); retired officers pay $3.80 a day; retired enlisted personnel pay nothing. The Department of Defense could save more than $65 million a year in budget authority and $325 million over the next five years by having nonactive-duty inpatients pay a deductible for hospital care similar to deductibles in other health plans.

Under this option, inpatients from enlisted families would pay a deductible of $100 on the first day of hospitalization; those from officers' families, $200. On succeeding days all inpatients would pay the present rates. No deductible would be charged if the patient returned to the hospital later in the year, even if the subsequent admission was for a new illness. (About 1 percent of beneficiaries enter military hospitals more than once a year.)

These larger deductibles would bring the military health-care system more in line with medical plans offered to civilian employees by the federal government. Most private-sector plans in the Federal Employees Health Benefits (FEHB) program charge flat dollar deductibles of between $100 and $200. Medicare beneficiaries must pay a deductible of $400, the average cost of one day's hospital stay.

Higher deductibles might also discourage some unnecessary admissions. Dependents of active-duty personnel seem to use more inpatient care than do civilians of comparable age and sex, perhaps because of the relative inexpensiveness of military hospital care. If deductibles lessened hospital admissions, military hospitals could free scarce resources for other medical uses, or DoD could realize additional savings in its health-care budget.

(These savings are not included in the above table.) And, if the Congress imposed outpatient fees in military clinics (see DEF-22), hospital deductibles would eliminate any incentive for people to substitute inpatient for outpatient care.

Increasing deductibles could lower personnel retention. Free or nearly free medical care is an important and long-standing benefit that military families value highly. If that benefit were taken away, some career personnel might be less willing to stay in the military. Although retention could suffer, the actual number of resignations should be small because less than 15 percent of military families use military hospitals in any year.

DEF-22 IMPOSE OUTPATIENT FEES AT MILITARY MEDICAL FACILITIES

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	95	100	105	110	120	530
Outlays	75	95	105	110	115	500

Patients using military physicians pay nothing for their medical care. By charging outpatients who are not on active duty between $5 and $10 for each visit, the Department of Defense could save at least $95 million in budget authority in 1986 and $530 million over the next five years. This option would link out-of-pocket expenses to ability to pay by charging members of enlisted families $5 a visit and officers' families $10. Charges would be limited to $100 a year for each enlisted family member and $200 for each officer family. These charges would increase yearly at the same rate as dependents' inpatient medical care charges. Charging outpatients would help DoD defray the $56 it spends on average for each outpatient visit. Administrative costs, which would offset part of this revenue, are reflected in the annual savings above.

Besides raising revenue, charging fees could also reduce the overcrowding in military clinics that results in long waiting lines. People probably overuse medical services that are free, thus forcing other beneficiaries to seek care from private providers and obtain repayment under the more costly Civilian Health and Medical Program of the Uniformed Services (CHAMPUS). Through reduced overcrowding, outpatient charges might bring many CHAMPUS patients back to military facilities. Less recourse to CHAMPUS could save DoD another $585 million through 1990. (These savings do not appear above because their realization is less certain.)

Because medical care is an important part of military compensation, military families would view outpatient charges as an erosion of benefits. Recruitment, and especially retention, could suffer. But the adverse effects should be modest. The average yearly cost to the military would be small--less than $100 a year for officers and $50 for enlisted families. Nor should a fee significantly harm health, a concern of some, since evidence shows that people at ages and income levels typical of military beneficiaries seek necessary medical care even when they share the costs.

The $100 and $200 limits should ensure that no one person bears very high expenses. Still, a few families that make very heavy use of outpatient services could spend over $300 a year. Although these families would make up less than 1 percent of all military families, fees could force some poorer families to forgo needed medical care. If problems do in fact develop, a program of outpatient charges could be modified to require smaller fees (or even no fees) from those least able to pay.

DEF-23 ELIMINATE THE ANNUAL MILITARY PAY RAISE

Savings from Admin. Request	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	1,900	2,000	2,100	2,200	2,400	10,600
Outlays	1,300	1,400	1,400	1,500	1,600	7,200
Savings in Defense Budget a/						
Budget Authority	1,900	2,000	2,100	2,200	2,400	10,600
Outlays	1,900	2,000	2,100	2,200	2,400	10,600

a. Savings in the federal and DoD budgets are different because of the effects of accrual accounting applied to retirement costs of military personnel. For a discussion of accrual accounting, see DEF-19.

Under current law, military personnel should receive annual pay raises in October 1985, designed to keep pace with wage increases in the private sector. The Administration proposes to move the raise to July 1985, and limit it to 3 percent, about enough to match the growth in private civilian wages that CBO expects to occur over 1985. Eliminating even this 3 percent raise, thus freezing military pay through fiscal year 1986, would save $1.9 billion over the Administration's request in 1986 and $10.6 billion over the next five years. (Post-1986 pay raises are assumed to keep pace with those in the private sector, with no adjustment for the 1986 freeze.)

A one-year pay freeze would make it harder for the Air Force and Navy to meet their various manpower goals. The retention of enlisted career personnel (those with four or more years of service) would slow and, because of rising manpower totals, their percentage of the enlisted force would shrink by about 2 percent by 1990. Still, CBO estimates that the Navy and Air Force would add about 18,000 people to their career forces over the same period. Recruitment should remain above recent historical levels, if not at the very high levels of 1983-1984, at least through 1988. After then, continuing growth in personnel could make the Navy's recruiting more difficult. Freezing pay could also worsen some shortages in hard-to-fill skills. If problems arise, they might have to be corrected at modest cost by increasing reenlistment bonuses or special pay, such as sea pay.

For the Army, freezing pay could worsen an already uncertain outlook brought on by improvement in the economy and current reenlistment policies. The effects would be most pronounced in 1986 when the Army would have only about 2,500 fewer career personnel than under present pay and personnel policy. CBO estimates that by 1990, however, this option would lower manpower levels by 13,500. (These losses are in addition to decreases of about 17,000 career enlisted members that CBO projects by 1990 under present pay and personnel policy.) In turn, these losses would increase the pressure on recruiting. Under a freeze, the Army could have difficulty keeping the proportion of male recruits with high school diplomas above 70 percent (compared with 80 percent to 90 percent in recent years), assuming that the proportion in the lowest acceptable category on the military's entrance examination would be held to under 12 percent (itself low by historical standards). Thus, freezing pay would erode the recruiting success of recent years, although the Army would continue to do better than it has historically.

Freezing pay would make it harder for the Army to meet its high quality objectives--goals that require 90 percent of male recruits to hold high school diplomas and two-thirds or more to score in the top half on entrance exams. These goals are currently under review by DoD and the Congress. If the goals are accepted, a pay freeze now might increase the need for later increases in special incentives, such as enlistment or reenlistment bonuses or educational incentives.

The Army could modify various personnel policies to mitigate the effects of a freeze in pay, although the Army might regard these changes as undesirable. For example, if the Army loosened its controls on reenlistments, its career force might decrease by about 1,000 people by 1990; meanwhile, high school graduate recruitment would improve several percentage points. Also, the Army could recruit more women, or people with prior military service, who generally are not in short supply.

In short, the recruitment and retention successes of recent years, perhaps in combination with some policy changes, should allow the services to accommodate a one-year pay freeze. In the long run, however, military pay raises must keep pace with increases in private-sector pay if the services are to avoid problems in both recruiting and retention.

ENTITLEMENTS AND OTHER MANDATORY SPENDING

This category presents 22 options that would either reduce outlays for entitlements and other mandatory spending or increase revenues earmarked to pay for these programs. ENT-1 through ENT-12 deal with health care programs. ENT-13 through ENT-16 discuss alternatives for reducing net federal outlays for Social Security and other retirement and disability programs. ENT-17 through ENT-22 deal with other entitlements, including non-means-tested and partially means-tested benefits, means-tested benefits, and grants to state and local governments.

Several of the options are substitutes for one another. Also, in some instances, the individual summaries describe more than one specific policy alternative. The savings from the separate options--or from the variants within a single option--cannot be added together to arrive at a total.

All estimates of outlay savings and revenue gains from these options are calculated relative to the CBO baseline budget projection. The baseline projections assume CBO's short-run economic forecast and longer-run projections, as described in its report, *The Economic and Budget Outlook: Fiscal Years 1986-1990.* Baseline spending projections for entitlements and other mandatory spending programs reflect forecast changes in caseloads and in the average federal cost per beneficiary resulting, for example, from cost-of-living adjustments in benefit payments or increases in either the price of medical services or the intensity of their use.

ENT-01 TAX SOME EMPLOYER-PAID HEALTH INSURANCE

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Income Tax	3.5	5.7	6.9	8.6	10.5	35.3
Payroll Tax	1.4	2.2	2.8	3.5	4.2	14.1

Employees do not pay taxes on income received as employer-paid health care coverage. This exclusion will reduce 1986 income tax revenues by approximately $17.0 billion. This form of income also escapes payroll taxation, costing the Social Security trust funds an additional $6.6 billion in lost 1986 revenues.

One option for limiting the exclusion would be to treat as taxable income in 1986 any portion of employer contributions exceeding $175 a month for family coverage and $70 a month for individuals, with the amount indexed to reflect price increases. About 21 percent of income tax filing units would have been affected by a similar limit in 1984. The Congress has already adopted a similar approach with employer-paid group life insurance. The proposal would raise income tax revenues by $3.5 billion and payroll tax revenues by $1.4 billion in 1986. Over the 1986-1990 period, the revenue increases would amount to $35.3 billion and $14.1 billion, respectively. "Grandfathering" of current high-cost health insurance plans would reduce these amounts.

Both health-policy and tax-policy arguments have been made for limiting this exclusion. The exclusion leads to what many consider to be overly extensive health insurance coverage, which has expanded use of health care services unnecessarily and, consequently, driven up their prices. Moreover, the provision disproportionately benefits people with higher incomes, both because they tend to have somewhat larger employer-paid health insurance premiums that are excluded from taxation and because they are in higher marginal tax brackets. The average annual tax benefit from excluding employer-paid health insurance premiums in 1984 for tax filers with incomes between $10,000 and $15,000 is estimated at $85; for tax filers with incomes between $50,000 and $100,000, it is $641.

Opponents argue that even those people with the most extensive coverage are not covered excessively and that changing the current policy would lower their insurance coverage; this might, in turn, cause some of them to forgo some forms of medical care. They further argue that a uniform ceiling would have uneven effects, since a given employer's contribution purchases different levels of coverage depending on such factors as geographic location and the demographic characteristics of the firm's work force.

ENT-02 REDUCE HOSPITAL REIMBURSEMENTS UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Limit Increases in Medicare's Prospective Payment Rates						
Budget Authority	-90	-280	-510	-810	-1,180	-2,870
Outlays	1,500	2,150	2,500	2,850	3,300	12,300
Reduce Medicare's Payments for Indirect Medical Education Costs						
Budget Authority	-20	-55	-110	-170	-260	-615
Outlays	310	430	580	650	720	2,700
Reduce Medicare's Payments for Direct Medical Education Expenses						
Budget Authority	-15	-40	-70	-100	-150	-375
Outlays	240	270	300	330	370	1,500

NOTE: Budget authority for the Hospital Insurance component of the Medicare program reflects all sources of income to the trust fund, including interest earned on reserves. Therefore, options that would reduce outlays also would allow reserves and interest income to increase. This accounts for the different arithmetic sign of budget authority and outlays in some of the entries.

The Social Security Amendments of 1983 established a prospective payment system (PPS) that provides hospitals with strong incentives to reduce costs. Under the new system, payment rates are set in advance for each of 468 diagnostic categories, known as diagnosis related groups (DRGs). Hospitals bear the burden if their costs exceed the fixed DRG payments, and they retain the surplus if their costs are lower. During the three-year phase-in period (fiscal years 1984-1986), prices will be based in part on prospective hospital-specific rates, in part on 18 regional rates (separate urban and rural rates for each of nine census regions), and in part on a single national urban or national rural rate. The final system will have only national urban and rural rates. Under the PPS, additional payments are made to hospitals for patients whose length of hospital stay or costs are unusually high, and for indirect medical education costs. The PPS rates currently do not cover capital-related costs (depreciation, interest, and rent) and direct medical education costs (residents' stipends, teachers' salaries, and administrative costs), which are reimbursed under a "reasonable cost" system.

Hospital reimbursements under Medicare might be reduced in the future in several ways: limit increases in Medicare's prospective payment rates; reduce Medicare's payments for indirect medical educaton costs; and reduce Medicare's payments for direct medical education costs.

Limit Increases in Medicare's Prospective Payment Rates. Beginning in 1987, Medicare's prospective payment rates to hospitals will be adjusted annually at the discretion of the Secretary of Health and Human Services. The 1986 adjustment will also be made by the Secretary but by law cannot exceed the growth rate in prices of goods and services purchased by hospitals (known as the market basket) plus one-quarter of a percentage point. The CBO baseline assumes the Secretary will allow annual increases equal to this limit in 1986 and in following years.

If the Congress froze the 1986 payment rates at their 1985 levels and limited future increases in the Medicare payment rate to the changes in the hospital market basket--not allowing the extra one-quarter of a percentage point--the savings through 1990 would be $12.3 billion. Moreover, restricting the increase would give hospitals greater incentives to become more efficient and to avoid procedures that are unnecessary or of limited value.

On the other hand, although admissions actually dropped in 1984, in the long run hospitals would have incentives to make up for the reduced Medicare revenue by admitting more patients, raising outpatient fees, and charging more to non-Medicare patients. Hospitals with predominantly Medicare patient populations might be forced to cut back services or close. Finally, high-cost beneficial advances in medical treatment might not be available to Medicare patients.

Reduce Medicare's Payments for Indirect Medical Education Costs. The prospective payment system includes higher payment rates to cover the additional patient care costs (that is, costs of treating each Medicare case) incurred by hospitals with teaching programs. These costs are known as indirect medical education costs. Hospitals with approved medical education programs receive an addition of 11.59 percent to the DRG portion of their payment for each 0.1 increase in the hospital's ratio of full-time equivalent interns and residents to its number of beds. This addition is double the estimate by the Health Care Financing Administration (HCFA) that a

0.1 increase in that ratio increases the cost of a Medicare case by approximately 5.8 percent. If this adjustment were reduced to 8.7 percent beginning in fiscal year 1986--halfway between the current statutory adjustment and the HCFA estimate--five-year savings would approach $2.7 billion.

The major argument for reducing the indirect medical education payments is that the current double adjustment factor overcompensates for any effect that a teaching program has on a hospital's costs for patient care. Hospitals may respond to this adjustment by substituting interns and residents for other medical personnel in a way that might not otherwise occur given relative wages and levels of productivity in providing patient care.

The issue of indirect medical education costs is very complex, however, and a uniform reduction may at best be a short-term solution. Many contend that the indirect teaching adjustment serves as a proxy to compensate for a number of factors that may legitimately increase costs--severity of illness of patients and inner-city locations of large teaching hospitals, for example--that are not adequately accounted for by the current DRG prices. Moreover, it is difficult to distinguish from these factors the effects that teaching programs have on costs of patient care. Finally, others argue that teaching hospitals provide the bulk of uncompensated and charity care to indigent patients, and that limiting the indirect teaching payments could reduce their ability to provide this care.

Reduce Medicare's Payments for Direct Medical Education Expenses. The direct costs of graduate medical education, which are currently excluded from the PPS, are reimbursed in proportion to the share of each hospital's total cost generated by Medicare patients. If this passthrough of direct medical education costs to Medicare were reduced by 25 percent beginning in fiscal year 1986, five-year savings would be approximately $1.5 billion.

There are several arguments for limiting this passthrough, which currently pays for nearly one-third of the direct costs of graduate medical education. First, other federal programs that subsidize medical education have been cut back in recent years because of an expected surplus of physicians and budgetary constraints. Second, the current system encourages expanding the direct costs of residency programs; reducing the level of reimbursement would lower--and might reverse--this incentive. Finally, some argue that the Hospital Insurance payroll tax is an inappropriate source of medical education subsidies, since those who benefit will generally earn incomes far higher than employees who pay the tax.

There are several drawbacks to reducing the direct medical education passthrough, however. First, because medical residents provide care to

Medicare beneficiaries, setting a fair limit on the passthrough might be difficult. Few data are available to estimate the proportion of medical education costs that cover patient care. If the passthrough rate were set too low, other payers might be forced to subsidize care for Medicare patients since the current DRG prices do not reflect the costs of patient care provided by residents. Second, fewer physicians may be trained if hospitals responded to lower Medicare payments by cutting the size of the residency programs. While this might be desirable in those specialties experiencing the largest surplus, it could restrict training of physicians in other areas such as primary care. Finally, hospitals might decide to cut costs by reducing residents' salaries, thereby lowering their incomes during this portion of their training.

ENT-03 EXTEND FREEZE ON PHYSICIANS' FEES PAID BY MEDICARE FOR ONE MORE YEAR

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	540	620	710	770	770	3,410
Outlays	490	560	650	740	740	3,180

Medicare currently reimburses physicians under the Supplementary Medical Insurance (SMI) program for "reasonable" charges for all covered services. A reasonable charge for a given service is the lowest of the physician's actual charge, the physician's customary charge for that service, and the prevailing charge for that service in the local community. This is known as the customary, prevailing, and reasonable (CPR) system.

Since the mid-1970s, the allowed rate of increase in prevailing fees has been limited to the rate of increase in an economywide index of office expenses and earnings--the Medicare economic index (MEI). The rate of increase in allowed fees has exceeded the MEI, though, because not all physicians' customary fees are at the ceiling set by prevailing fees. (About 60 percent of claim dollars were at the ceiling in July 1984.) Under the Deficit Reduction Act, physicians' allowed fees under Medicare were frozen for 15 months through September 30, 1985. This was accomplished by eliminating the update of both prevailing and customary fees that would otherwise have occurred on July 1, 1984, and by delaying until October 1, 1985, the update that would have occurred in July 1985.

The current freeze could be extended for another year, until October 1, 1986. Savings would be $490 million in 1986, and $3.2 billion through 1990. (These estimates assume a return to the CPR system in fiscal year 1987 and an update of all customary fees at that time. Prevailing fees, however, which were last adjusted in July 1983, would increase only by the increase in the MEI during fiscal year 1986. Estimates for 1987 and beyond would, of course, be different if more far-reaching changes in physicians' reimbursement were enacted at that time.)

This option would generate savings relative to current law, while giving the Congress additional time to develop an alternative to the CPR system. Out-of-pocket costs for Medicare beneficiaries would not increase during the period of the freeze at least, since the current law effectively freezes physicians' charges to Medicare patients as well as Medicare's reimbursement rates. (Litigation now under way will determine whether extension of this freeze on physicians' charges is possible.) On the other hand, extending the freeze would mean that allowed fees under Medicare will have been unchanged since July 1983 for all physicians, even those with relatively low fees, while their costs have risen. This could increase reluctance of physicians to treat Medicare patients.

One alternative would be to modify the freeze by updating customary fees only for those physicians who were "participating physicians"--that is, who agreed to accept assignment for all their Medicare patients--during fiscal year 1985. (By accepting assignment, physicians agree to accept Medicare's allowed rates; patients are not billed for any excess of submitted charges over the allowed rates.) There would be no update on prevailing fees or on customary fees for nonparticipating physicians. Under this option, savings would be $390 million for 1986 and $2.9 billion over the five-year period. This would reward participating physicians by allowing their Medicare payment rates to increase if their customary fees are lower than prevailing fees in their community. Further, it would reduce the current variation in the rate that Medicare pays for a given service, making it less disruptive to implement uniform payment rates later as part of any major changes in the system.

ENT-04 ADOPT A FEE SCHEDULE FOR REIMBURSING PHYSICIANS UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	540	780	1,000	1,300	1,600	5,220
Outlays	490	650	890	1,200	1,400	4,630

As discussed in ENT-03, fees for physicians under Medicare's Supplementary Medical Insurance program have been frozen through September 30, 1985. As an alternative to continuing the current freeze or returning to the customary, prevailing, and reasonable (CPR) method of fee determination, a fee schedule based on the nationwide average of allowed amounts for each procedure--with adjustment for local differences in costs--could be put in place in October 1985. The fee schedule that would be effective from October 1, 1985, through September 30, 1986, could be set by average amounts allowed for each procedure during the previous year, with annual increases thereafter determined by the rate of increase in the Medicare economic index (MEI). Savings under this option--if fully implemented in October 1985--would be $490 million for 1986, and would total $4.6 billion over the five-year period, 1986-1990. Alternatively, this change could be phased in, for example, by freezing fees that are now higher than they would be under the new schedule until the new schedule caught up. Physician acceptance of the fee schedule might be enhanced, but savings would be lower.

Under the first approach, physicians with low fees would receive higher payment rates in fiscal year 1986, while physicians with high fees would have lower payment rates than previously. Savings for 1986 would be the same as if the current freeze were continued, but savings would be larger in later years because fee increases initiated by physicians would no longer directly affect Medicare reimbursements. Fees paid by Medicare would increase only in response to increases in physicians' office expenses or to higher national earnings per capita.

One problem with a fee schedule, however, is that a schedule based on average allowed amounts would incorporate elements of the current fee structure that many believe need to be corrected, such as more generous payments for inpatient services relative to similar care provided in physicians' offices, and excessive payments for certain procedures that are either ineffective or far less costly to perform now than when they were first introduced. Another problem is that control of costs probably requires constraints on volume of services provided as well as on fees. Although modification to the rate structure and the introduction of volume controls could be made incrementally following implementation, an alternative would be to delay major reform of physician payment methods until further studies are completed.

ENT-05 INCREASE MEDICARE'S PREMIUM FOR PHYSICIANS' SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	1,650	2,550	3,300	4,300	5,400	17,200
Outlays	1,650	2,550	3,300	4,300	5,400	17,200

Medicare's Supplementary Medical Insurance program is partially funded by monthly premiums--currently $15.50--paid by beneficiaries. Between 1972 and 1982, premium receipts covered a declining share of SMI costs--dropping from 50 percent to 25 percent--because premiums were tied to the rate of growth in Social Security benefits, which is based on the Consumer Price Index, rather than to the faster-rising per capita cost of SMI. In 1982, premiums were set through 1985 (later extended through 1987) to cover 25 percent of the average benefits for an elderly enrollee. Under current law, beginning in 1988 the premium calculation will again be limited to the rate of growth of Social Security benefits. If, instead, the premium were set so that participants would pay 35 percent of benefits beginning January 1, 1986, and for all years thereafter, savings would total $1.7 billion in fiscal year 1986 and $17.2 billion over the five-year period. The estimated premium would be $24.30 on January 1, 1986, instead of the scheduled $17.30. These estimates incorporate the provision in current law that limits the application of a scheduled premium increase when it would exceed the dollar value of a person's cost-of-living increase under Social Security.

Under this option, the increase in payments would be shared by all enrollees, in contrast to other alternatives that affect only the users of medical services, who may be more financially pressed during the period of illness. Also, it would not affect the poorest since they are likely to be eligible for Medicaid, which usually pays the SMI premium on their behalf. For those not eligible for Medicaid, the higher premium would be about 5 percent of the average monthly Social Security benefit in 1986, slightly more of a burden than in 1967--the first full year for Medicare--when the premium was 3.6 percent of the average Social Security benefit.

Some current enrollees would find the increased premium burdensome, however. Some might drop SMI coverage and either do without care or turn to sources of free or reduced-cost care, which would increase demands on local governments. One alternative would be to raise gradually the share of benefits financed by premiums, increasing it from 25 percent to 35 percent over a five-year period. This phased increase would lessen the burden on beneficiaries, but would reduce five-year federal savings to $12 billion. Another alternative would be a supplementary income-related premium, discussed in ENT-06.

ENT-06 USE THE TAX SYSTEM TO IMPOSE A SUPPLEMENTARY INCOME-RELATED PREMIUM FOR PHYSICIANS' SERVICES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year
	1986	1987	1988	1989	1990	Addition
Addition to CBO Baseline	0.1	0.4	0.5	0.5	0.6	2.1

Part B of Medicare offers Supplementary Medical Insurance (SMI), which covers a portion of enrollees' physician and other nonhospital charges. Participation is voluntary, and enrollees currently pay a monthly premium of $15.50. The premium is adjusted annually to cover 25 percent of the average costs incurred by an elderly enrollee. The balance of costs, nearly $20 billion for 1986, is paid from general revenues.

An alternative to increasing the share of costs financed by the current premium--which might reduce enrollment among lower-income beneficiaries--would be to impose a supplementary income-related premium. This could be most conveniently introduced through the income tax system, to avoid having to set up a new bureaucracy to collect means-tested premiums from enrollees.

A 1 percent tax could be imposed on enrollees' taxable income. A ceiling on added tax liability for each tax unit (usually the household) could be set by the number of SMI enrollees in the unit times the average value of subsidized SMI benefits per enrollee, so that no unit would pay more than the full actuarial value of its benefits. If an SMI tax of 1 percent were imposed on taxable income for all units with at least one SMI enrollee during the tax year, revenues earmarked for the SMI trust fund would be increased by $0.1 billion in 1986, and by $2.1 billion over the five-year period.

Although this approach would increase tax liabilities for a substantial proportion of SMI enrollees, the poorest enrollees--those with no taxable income--would not be affected. For those with taxable income, the percent increase in their tax liability--but not the dollar amount of the tax increase --would be larger for lower income people. Some might consider the tax inequitable since the amount of tax paid by each tax unit would not vary with the number of SMI enrollees in a unit except for a small number of high-income tax units affected by the ceiling.

ENT-07 TAX A PORTION OF MEDICARE BENEFITS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	0.5	1.8	2.1	2.3	2.6	9.3

Eligibility for Hospital Insurance (HI) benefits is based on working-year tax contributions, half of which are paid by employees from after-tax income and half by employers from pre-tax income. Eligibility for Supplementary Medical Insurance (SMI) depends on payment of a premium, which currently covers about 25 percent of SMI benefits. Hence, 50 percent of the insurance value of HI benefits and 75 percent of the insurance value of SMI benefits might be treated as taxable income for enrollees, effective January 1, 1986, with the resulting tax proceeds returned to the Medicare trust funds. This proposal is analogous to the taxation of Social Security benefits, which is already part of the law for beneficiaries with incomes exceeding $25,000 (for individuals) or $32,000 (for couples).

If the current income thresholds for the tax on Social Security benefits were used to limit the application of the tax on Medicare benefits, too--with taxable Medicare benefits added to taxable Social Security benefits to compare to the threshold--taxing both HI and SMI benefits would yield additional revenues of $0.5 billion in 1986 and $9.3 billion over the five-year period 1986-1990. If no income thresholds were used to limit the application of the Medicare tax, additional revenues would be $0.7 billion in 1986 and $11.2 billion over the five-year period.

A tax on HI benefits would strengthen the HI trust fund. A tax on SMI benefits would shift some SMI costs from the general taxpayer to beneficiaries without increasing costs for low-income beneficiaries and thereby not threatening their access to care. Benefits provided to Medicare enrollees would not be reduced. Since this option would use the mechanism already in place for taxing Social Security benefits, it would present no additional administrative difficulty.

On the other hand, because of their better health, people with higher incomes are typically less costly to the Medicare program, so that requiring them to pay a relatively greater share of the costs might be viewed as inequitable by some. If the income thresholds were eliminated, tax liabilities for elderly couples with taxable income would increase by $350 to $1,500 in 1986. Further, unlike the tax on Social Security benefits, this tax would be imposed on the insurance value of in-kind benefits rather than on dollar benefits actually received--a modification of current tax policy. Finally, some might object to this tax because enrollees could not alter their tax liability by choosing a different package of benefits, except by dropping SMI coverage altogether.

ENT-08 INCREASE MEDICARE'S DEDUCTIBLE FOR PHYSICIAN SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	850	1,200	1,400	1,500	1,750	6,700
Outlays	610	1,050	1,250	1,450	1,600	5,960

Appreciable federal savings in Medicare's Supplementary Medical Insurance program could be realized by increasing the deductible--that is, the amount that beneficiaries must pay for services each year before the government shares responsibility. The deductible is now $75 a year. This deductible has been increased only twice since Medicare began in 1966, when it was set at $50. Hence, the deductible has fallen relative to average per capita benefits from 70 percent in 1967 to an estimated 10 percent for 1985. Increasing the SMI deductible to $200 on January 1, 1986, and indexing it thereafter to the rate of growth in the Consumer Price Index would save $610 million in fiscal year 1986 and $6 billion over the five-year period 1986-1990.

Such an increase would spread the burden of reduced federal outlays across most beneficiaries, raising their out-of-pocket costs by no more than $125 each in 1986. Since a larger proportion of beneficiaries would not exceed the deductible (currently about 35 percent do not), there would be more beneficiaries with maximal incentives for prudent consumption of medical care, and administrative costs to process claims also could be reduced.

On the other hand, even relatively small increases in out-of-pocket costs could prove burdensome to low-income beneficiaries who do not qualify for Medicaid. That might, in turn, discourage some people from seeking needed care.

ENT-09 INCREASE COST SHARING FOR MEDICARE AND ADD CATASTROPHIC PROTECTION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	690	840	810	610	500	3,450
Outlays	1,710	2,760	3,230	3,740	4,250	15,690

Under current law, physicians' services and hospital outpatient care are reimbursed under the Supplementary Medical Insurance (SMI) component of Medicare, while hospital, skilled nursing, and home health care services are reimbursed under the Hospital Insurance (HI) program. Each program has its own financing, deductible, and cost-sharing provisions.

The HI and SMI components of Medicare could be better coordinated, with coverage expanded to provide a cap on out-of-pocket expenses for covered services under either part of Medicare. This catastrophic benefit could be entirely financed by a premium set for a new Part C of Medicare, which could be a required addition for those electing SMI coverage. A deductible of $200 could apply for all SMI services, with the amount indexed to the rate of growth in the Consumer Price Index (CPI). In addition, a deductible equal to the average cost of a hospital day (currently $400) could be required for each hospital admission, while eliminating all coinsurance payments for hospital stays. After the deductibles were met, coinsurance of 20 percent of costs could be required on all services except hospital stays, with beneficiaries' maximum annual liability for cost sharing through the HI and SMI deductible and coinsurance provisions limited to $2,000. This limit, too, could be indexed to the rate of growth in the CPI. If implemented on January 1, 1986, estimated savings under these combined provisions would total $1.7 billion in 1986, and $15.7 billion over the five-year period 1986-1990.

The prospective payment system for hospital reimbursement, while providing incentives to hospitals to limit extended stays by releasing patients as soon as they are well enough, may at the same time encourage multiple admissions or admissions for procedures or tests that could be done on an outpatient basis. Applying a per-admission deductible would reduce that potential problem by requiring patients to pay the full first-day costs for each admission. (Contrary to expectations, however, Medicare admissions did not increase in 1984.)

Requiring a coinsurance rate of 20 percent of daily costs for all services except hospital stays would simplify Medicare's cost-sharing provisions and would give enrollees an incentive lacking now to reduce their use of skilled nursing facilities and home health services. Total health care costs could decline because of reduced use of services induced by the higher copayments required of beneficiaries, although this decrease might be small since 75 percent to 80 percent of beneficiaries have supplemental coverage for copayments. Further, any decline in costs could be offset by potentially greater costs for patients who exceed the catastrophic cap. One longer-term benefit of a catastrophic cap might be to reduce the proportion of enrollees who purchase supplementary coverage, thereby eliminating their Medigap premium costs and increasing the effect of Medicare's cost-sharing provisions on reducing their demand for services.

Preliminary estimates indicate that total copayments would be virtually unchanged in 1986 under this option, equal to about $400 per enrollee. Copayments would increase for most enrollees not using hospital services during the year, however, and fewer than 1 percent of these enrollees would benefit from the cap on copayments. For enrollees admitted to the hospital, average copayments would fall. About 23 percent of enrollees using hospital services, and 5 percent of all enrollees, would benefit from the catastrophic cap in 1986. Although each enrollee's annual out-of-pocket costs for covered services would be capped at $2,000, enrollees would still be liable for disallowed charges, noncovered services, and premium costs.

The annual Medicare premium for 1986 would be about $200 for Part B, and about $75--or $6.25 monthly--for the new Part C. The Part C premium would be higher if benefits were expanded to include the costs of long hospital stays (over 150 days a year) and nursing facility stays (over 100 days), which are not currently covered by Medicare. The premium would also be higher if more services were used by enrollees who approached or exceeded the cap.

ENT-10 TAX PREMIUMS FOR "MEDIGAP" POLICIES

Addition to CBO Baseline	Annual Added Revenues (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Impose a 30 Percent Tax on Premiums for Medigap Policies	3,150	4,550	4,950	5,400	5,850	23,950

Over 60 percent of all Medicare participants purchase (or receive from employers) private coverage to supplement Medicare. These plans--known as "Medigap" policies--reduce patients' out-of-pocket payments for Medicare's deductible amounts and coinsurance. Although the plans vary widely, they often pay all the cost-sharing portions of Medicare (for example, the 20 percent coinsurance for physicians' charges). Consequently, people with Medigap coverage use services at a higher rate than those covered only by Medicare, yet Medicare pays most of the costs of these additional services (for example, 80 percent of physicians' reasonable charges).

To recoup the extra federal outlays arising from greater use of health care by holders of supplemental coverage, a tax of 30 percent could be imposed on premiums for Medigap policies that pay any part of the first $1,000 of Medicare's required cost sharing. This proposal would not affect the prevalence of insurance protection for unusually large health costs. Federal savings would stem both from the premium tax receipts and from a reduction in use of health care by those who would drop Medigap coverage or change the type of policy to avoid an increase in premiums. The additional revenues, which could be dedicated to the two Medicare trust funds, plus the outlay reductions would total $3.2 billion in 1986 and $24 billion over the 1986-1990 period.

This option would lead to more equal federal aid for all participants by requiring those with Medigap coverage to bear the additional costs they impose on Medicare. Moreover, the reduced use of services might help to slow the growth in health care costs. Finally, very low-income elderly and disabled people would not be affected, since Medicaid pays their deductible amounts and coinsurance.

The premium tax would, however, increase the cost of the current type of Medigap policies and therefore discourage their purchase. Some who would otherwise have purchased supplemental coverage would have trouble meeting out-of-pocket costs during a year of unusually high medical expenditures. Without Medigap coverage, beneficiaries could pay as much as $1,000 in cost sharing, which could represent a substantial portion of their incomes.

ENT-11 INCREASE THE HOSPITAL INSURANCE PAYROLL TAX

Addition to CBO Baseline	Annual Added Revenues (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Increase Payroll Tax Rates by Half a Percentage Point	13,900	19,000	20,500	22,000	23,600	99,000

The Hospital Insurance (HI) component of Medicare, which accounts for almost 70 percent of total program outlays, is financed by a portion of the Social Security payroll tax. Employees covered by the HI program and their employers currently each contribute 1.35 percent of the first $39,600 of earnings. The tax rate is scheduled to increase to 1.45 percent in 1986, and the taxable earnings ceiling rises automatically with average wages.

Increasing the HI payroll tax rate would reduce the federal budget deficit and help maintain the solvency of the HI trust fund, which is projected to be depleted in the mid-1990s. A 0.5 percentage-point increase in the tax rate for both employers and employees beginning in 1986 would generate $99 billion in revenues over the 1986-1990 period, and would delay depletion of the trust fund.

Some argue, however, that payroll taxes are already too high. Currently scheduled increases mean that the combined employer and employee Social Security tax rate--for retirement benefits, disability payments, and Medicare--will have increased by 3.6 percentage points between 1975 and 1990, from 11.7 percent to 15.3 percent. Moreover, Social Security payroll taxes already account for an increasing share of total federal revenues--rising from 26 percent in 1980 to about 34 percent in 1989. Further increases in the payroll tax could have adverse effects on employment and inflation, because the cost of hiring workers would rise. In addition, this option would increase both the relative and absolute tax burden of those with lower earnings, because the tax applies only to earnings below a specified limit.

ENT-12 LIMIT PAYMENTS FOR LONG-TERM CARE SERVICES THROUGH A BLOCK GRANT

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	850	1,150	1,450	1,750	2,100	7,300
Outlays	850	1,150	1,450	1,750	2,100	7,300

Appreciable savings could be realized by transforming Medicaid's funding for long-term care services into a block grant. States would have to match the federal grant based on current rates, and for the first year each state would receive the 1985 amount. After 1986, federal grants could reflect adjustments relative to state population and other factors, such as the probable use of services in an area, the number of poor elderly and disabled people in the state, and a per capita payment for each type of service adjusted for the local costs of long-term care services. Increases in total federal payments, however, would be limited to the inflation rate for medical care. Federal savings over the next five years could accrue to $7.3 billion.

Advocates of such a plan believe that it would encourage states to serve their long-term care patients more cost-effectively. Given more flexibility in the use of funds, states would be encouraged to substitute lower-cost services, such as home and community-based care, for costly services, such as institutionalizing all mentally ill or mentally retarded patients for long periods.

Opponents of a block grant for long-term care fear that too much responsibility and financial burden would be shifted to the states. They believe that if federal funding is decreased, some needed services would not be provided because some states would not provide supplemental funding. To provide adequate and quality care, some states would have to either increase local taxes or perhaps reduce some benefits to the less-poor beneficiary population. Others suggest that some states might respond to the plan by increasing the use of acute-care services that would still be partially funded by the federal government.

An additional option would be to fold current funding for long-term care under the Social Services Block Grant (SSBG) into the new grant. While the exact amounts of SSBG funds used this way by each state would have to be estimated, one program instead of two would likely be administratively superior. States would allocate resources from a single agency and would delegate to local agencies or contractors the necessary screening of and health care planning for patients.

ENT-13 RESTRICT COST-OF-LIVING ADJUSTMENTS IN NON-MEANS-TESTED BENEFIT PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Eliminate COLAs for One Year						
Social Security/ Railroad Retirement	5,400	7,400	7,450	7,450	7,250	34,950
Other Non-Means-Tested Programs	1,450	1,950	2,000	2,050	2,100	9,550
Offsets in Means-Tested Programs	-630	-360	-210	-190	-180	-1,550
Total	6,200	9,000	9,250	9,300	9,200	42,950
Limit COLAs to Two-Thirds of CPI Increase for Five Years						
Social Security/ Railroad Retirement	1,750	4,700	7,800	11,000	14,350	39,600
Other Non-Means-Tested Programs	470	1,250	2,050	2,700	3,300	9,800
Offsets in Means-Tested Programs	-50	-120	-290	-460	-620	-1,550
Total	2,150	5,800	9,600	13,300	17,050	47,850
Limit COLAs to CPI Increase Minus 2 Percentage Points for Five Years						
Social Security/ Railroad Retirement	2,900	7,050	11,350	15,900	20,500	57,700
Other Non-Means-Tested Programs	770	1,850	3,000	4,200	5,450	15,250
Offsets in Means-Tested Programs	-80	-190	-410	-650	-880	-2,200
Total	3,600	8,700	13,950	19,400	25,100	70,750
Pay Full COLA on Benefits Below a Certain Level and 50% of COLA on Amounts Exceeding That Level						
Social Security/ Railroad Retirement	740	1,950	3,250	4,550	5,850	16,350

Annual cost-of-living adjustments (COLAs) account for nearly 60 percent of the growth in non-means-tested cash benefit programs. Reducing these automatic increases is commonly proposed as an effective way to slow the growth in entitlement spending. Four strategies for reducing COLAs and the savings resulting from each option are shown in the table on the previous page.

Advocates of COLA restrictions view them as a means of generating considerable budgetary savings while spreading the effects across the entire beneficiary population, as compared with other budget options that focus their impacts on relatively small groups of recipients. They point to past problems with the indexing of benefits as reasons to support COLA limitations. For example, COLA restrictions have been suggested as a means of offsetting the impact that the upward bias in the Consumer Price Index (CPI) had on benefit increases, particularly during the 1979-1982 period. With regard to specific programs, COLAs for civil service annuitants have exceeded the wage increases received by federal workers in recent years, thereby increasing the incentives for retirement. Similar problems occurred in Social Security. Some analysts have also considered these COLAs to be overly generous to federal retirees, because the COLA applies to their entire benefit while private-sector employees generally can expect that their Social Security benefits, but not their private pension benefits, will be completely protected against inflation.

Opponents counter that budget-reduction strategies that institute less than complete price indexing would result in financial difficulties for many recipients, particularly if they were applied for an extended period. For example, if inflation adjustments were made only for price increases in excess of 3 percent and inflation were to stabilize at a 4 percent annual rate, purchasing power of benefits would decline by almost 14 percent over five years. Although the exclusion of means-tested benefit programs such as Supplemental Security Income and Food Stamps would limit the impact of COLA reductions for many of the poorest beneficiaries, many others would face substantial declines in their standards of living. More than 2 million elderly people have incomes between 100 percent and 125 percent of poverty, and a benefit change of this magnitude would significantly raise poverty rates for this subgroup of the population. To the extent that hardships or inequities arise, the Congress can correct them later through discretionary action, but then, of course, budgetary savings would be reduced.

COLA reductions also encounter opposition from those who fear that changes made to reduce budget deficits would undermine the entire structure of retirement income policy. They argue that these programs should be altered only gradually and then only for programmatic reasons, because

Social Security and other retirement programs represent long-term commitments both to current retirees and to today's workers. Thus, any benefit changes should be announced well in advance to allow people to adjust their long-run plans. Moreover, when viewed as retirement policy, COLA restrictions would imply that it is federal policy to provide retirees with their highest real retirement incomes immediately after retirement and to lower real incomes thereafter, with retirees who survive longest having the largest decreases in real income. If these decreases became unacceptably large, however, discretionary benefit increases could be enacted.

Finally, if COLA limitations were adopted to restrict the growth in benefits for people after they retire, but no commensurate changes were made in the determination of initial benefits for new recipients, then significant disparities in benefit levels across different groups of retirees would be introduced. This situation is particularly relevant for Social Security, where benefits for those becoming eligible are based on an indexed benefit formula and on indexed earnings histories. For example, if prices rose by 5 percent in a year and the wage index used to compute benefits for newly eligible recipients increased by 6 percent, the elimination of that year's COLA without any change in the calculation of initial benefits would result in benefits for new beneficiaries that were about 6 percent higher than for recent retirees; under current law, benefits would be only about 1 percent higher for the new retirees. To mitigate this problem, efforts to slow the growth in benefits through COLA limitations might be extended to the formulas determining initial benefits, thus effecting similar benefit reductions for future recipients.

Several COLA options, and the extension of these options to the calculation of initial benefits for future recipients, are examined below.

Eliminate COLAs for One Year. One option would be to eliminate COLAs in fiscal year 1986 for non-means-tested benefit programs, while allowing them to be paid in subsequent years but with no provision for making up the lost adjustment. If this approach were taken, federal outlays would be reduced by about $6.2 billion in 1986 and $43 billion over five years, with Social Security and Railroad Retirement accounting for about 80 percent of the total. Other affected programs include veterans' compensation and federal civilian and military retirement and disability programs. The magnitude of these reductions is very sensitive to the assumed level of inflation and would be larger or smaller if prices were to rise faster or slower than the 3.7 percent increase currently assumed for the fiscal year 1986 COLA. These savings are less than the gross reduction in non-means-tested retirement benefits, because some low-income beneficiaries would become eligible for larger benefits from means-tested entitlement programs, thereby offsetting some of the savings. Significant reductions in outlays would persist for some years because benefit levels for those affected would be permanently lowered as a result of the skipped COLA, although the savings would eventually disappear as beneficiaries died or ceased receiving payments for other reasons. If a corresponding proportionate reduction were enacted for future Social Security recipients as well, savings would be increased by about $3.7 billion over the five-year period and by more in future years.

Limit COLAs to Two-Thirds of CPI Increase. Under this option, recipients would be compensated for only a certain proportion of inflation, such as two-thirds of the annual CPI increase. Under current CBO economic assumptions, applying this restriction for five years would save about $2.2 billion next year and $47.9 billion over the 1986-1990 period. As a result, benefits for people who received payments throughout the five-year period would be over 6 percent less in 1990 than they would have been under full price indexing. Both cumulative savings and benefit reductions would be greater in a higher-inflation environment and smaller under low inflation. A three-year restriction on COLAs would achieve $38.7 billion in five-year budgetary savings and would reduce 1990 benefits by 4 percent relative to current law. Extending the two-thirds rule to reduce the growth in benefits for new retirees would result in an additional $1.9 billion in spending reductions if applied for five years, and $1.3 billion if applied for only three.

Index Benefits by the CPI Increase Minus Two Percentage Points. An approach similar to the proportionate COLA reduction would be to reduce the adjustment by a fixed number of percentage points--for example, the CPI increase less two points. In this case, both savings and effects on beneficiaries would be roughly the same regardless of the level of inflation--about $70.7 billion over the next five years, if extended for the full period. If the restriction applied for only three years, the five-year savings would be $56.9 billion. (This option would affect all beneficiaries almost the same, regardless of the inflation rate, whereas the two-thirds-of-COLA approach would reduce the purchasing power of benefits most sharply when inflation is high.) If comparable benefit adjustments were also included for new Social Security recipients, the five-year savings would increase by about $2.7 billion.

Pay the Full COLA on the Portion of Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level. To ensure that lower-income beneficiaries would not be adversely affected by COLA reductions, some analysts have suggested tying the reduction to beneficiaries' incomes or payment levels. The example displayed here--based only on Social Security and Railroad Retirement Tier 1 benefits--would award the full COLA for benefits based on the first $400 of the retirees' primary insurance amount (PIA) and 50 percent of the COLA on benefits above this level; the $400 level would also be indexed by the full COLA. Outlays would decline by about $0.7 billion in 1986 and $16.4 billion over the 1986-1990 period. Similar changes in the Social Security benefit formula would add $1.1 billion to the five-year savings estimate.

Several concerns are raised regarding this approach, however. First, benefit levels are not always good indicators of total income. Some families with high benefits have very little other income, while some with low benefits have substantial income from other sources. On the other hand, targeting the COLA restraint on the basis of total income would be administratively complex, unless it were to be imposed retrospectively by using information from income tax returns. Second, if this proposal were extended to include other benefit programs, the different benefit structure in each program might require separate determinations of the appropriate benefit levels for paying the reduced COLA. For example, some proposals to restrict Civil Service Retirement COLAs have used $1,000 in monthly benefits as the threshold for full COLAs (see CIV-08 for further details), in order to provide benefits that are similar to those prevailing in the private sector where Social Security payments are indexed but private pension benefits are not. Third, many analysts object to any changes in retirement programs that might be construed as introducing a means test for benefits, even if the "test" is limited only to the COLA.

ENT-14 ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN OF RETIRES AGED 62-64

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	-5	-15	-35	-70	-120	-245
Outlays	50	190	360	600	670	1,870

NOTE: Budget authority reflects all income to the trust funds, including interest earned on reserves. Thus, options that reduce outlays also allow reserves and interest income to increase, thereby resulting in different arithmetic signs for budget authority and outlay changes.

Under current law, unmarried children of retired workers are eligible for Social Security dependents' benefits as long as they are under age 18, or attend elementary or secondary schools and are under age 19, or become disabled before age 22. The child's benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees aged 62 through 64, beginning with retirees reaching age 62 in October 1985, the savings would total about $1.9 billion over the next five years.

This option might encourage some retirees to stay in the labor force longer. At present, though benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, children's benefits are not. Further, the younger the workers are, the more likely they are to have children under age 18. Thus, workers under age 65 may have an incentive to retire now while their children are still eligible for benefits. This effect is likely to be quite small for many families, however, since the maximum family benefit limits the increase in a household's total benefits attributable to eligible children.

On the other hand, for families with workers whose retirement was not optional--because of poor health or unemployment, for example--the loss in family income might cause some hardship. Moreover, since spouses under age 62 receive benefits only if their children under age 16 also receive benefits, eliminating children's benefits for families of early retirees would also result in the loss of spouses' benefits in some families. In such cases, the total loss of income could be significant.

ENT-15 COVER ALL NEWLY HIRED STATE AND LOCAL GOVERNMENT WORKERS UNDER SOCIAL SECURITY

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Addition to CBO Baseline	210	770	1,400	2,050	2,650	7,050

With the enactment of the Social Security Amendments of 1983, the only major group of the work force who will not eventually be completely covered under Social Security is employees of state and local governments. About 70 percent of such workers are now covered, with the coverage rate ranging from zero percent in some states, such as Ohio and Massachusetts, to 100 percent in others, including Pennsylvania and New Jersey. If all state and local government workers hired after December 31, 1985, were brought under the Social Security system, federal revenues would increase by about $0.2 billion in 1986 and by nearly $7.1 billion during the 1986-1990 period. This option would also result in higher outlays in the future, but the increase would be negligible over the next five years. Over the long run, the net effect of the revenue and outlay increases--including Medicare expenses for those newly eligible--would be to improve slightly the trust fund balances.

Social Security coverage for new state and local government workers would, after only a few years, improve the protection many of these workers and their families would receive in the event of the worker's disability or death. This is because many public employee benefit programs have more stringent vesting requirements for such protection than does Social Security, especially for young workers. Moreover, since Social Security coverage is portable, workers who change jobs and would lose eligibility for benefits under the state and local plans might find Social Security coverage particularly advantageous. In addition, although some nonfederal benefit plans index benefits at least partially for inflation, the indexation of Social Security benefits is generally superior. Finally, since the current benefit formula causes some redistribution of benefits from high-wage workers to low-wage workers, it may be inconsistent to allow some group of workers not to participate.

One important and controversial aspect of proposals to require state and local employees to participate in Social Security involves a constitutional argument; namely, that the federal government cannot compel states and their municipalities to pay federal taxes--in this instance, the employer share of the payroll tax that would be levied on these subnational governments. In fact, although many tax experts insist that no such problem exists in this case, the constitutionality of the provision in the 1983 amendments that prohibited participating state and local governments from opting out of the Social Security system is currently being challenged in court. State and local government employees also might object to the requirement that they contribute to Social Security, because many of them establish eligibility for Social Security through jobs that they hold before and after their period of noncovered employment, and the additional benefits they would earn under this extension of coverage would often be less than the additional taxes they and their employers would pay. This objection is even stronger with regard to Medicare coverage, where only a minority of these workers would not qualify for benefits under current law either as workers or as spouses of insured workers. Finally, some question the adequacy of the funding for current state and local pension plans should new employees no longer be required to contribute to them, and express concern about the fiscal impact this option would have on affected jurisdictions.

ENT-16 ELIMINATE VETERANS' COMPENSATION PAYMENTS FOR THOSE WITH LOW-RATED DISABILITIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	1,400	1,450	1,500	1,550	1,600	7,500
Outlays	1,300	1,450	1,500	1,550	1,600	7,400

Veterans' disability compensation provides cash benefits to veterans with service-connected disabilities, based on the degree of their impairment, with additional allowances to certain recipients who have dependents. Eliminating all benefits for those with disability ratings below 30 percent, and ending dependents' allowances for those with ratings below 50 percent, would reduce federal outlays by about $7.4 billion between 1986 and 1990. Almost 1.26 million persons, or about 56 percent of all veteran beneficiaries, would lose all their cash benefits--currently between $66 and $122 per month--but they would retain their eligibility for medical care and other associated benefits. For another 320,000 veterans whose disability rating is 30 percent or 40 percent and who have dependents, benefits would be reduced by an average of about $40 per month.

Proponents believe that this option would target benefits toward the medically neediest of the disabled veterans and their families. It would also result in more comparable treatment of disabled veterans and recipients of disability benefits from other programs. Moreover, veterans' disability ratings were originally designed to indicate an average loss of earning power. With recent improvements in reconstructive and rehabilitative medicine, however, there is a question whether veterans with impairments rated below 30 percent suffer any reductions in their earnings as a result of their low-rated disabilities. Many of these veterans are compensated for impairments such as mild arthritis, moderately flat feet, or one partially amputated finger, which may not affect their ability to work. Likewise, dependents' allowances for veterans with disability ratings of 30 percent or 40 percent probably are not needed for income support.

Opponents, however, view these benefits as indemnity payments owed to veterans disabled to any degree while serving in the armed forces. Furthermore, some current beneficiaries have retired from work and could experience some reduction in their standard of living, even though the payments may be small.

ENT-17 REQUIRE A TWO-WEEK WAITING PERIOD FOR UNEMPLOYMENT INSURANCE BENEFITS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	--	--	--	--	--	--
Outlays	--	880	890	900	920	3,590

NOTE: These estimates assume that the change is not implemented until fiscal year 1987, to allow time for changes in state UI laws.

Current federal law imposes no mandatory waiting period before jobless workers can receive their initial Unemployment Insurance (UI) benefit payment. The Omnibus Reconciliation Act of 1980 did, however, require states to adopt a one-week waiting period on regular UI benefit payments or lose some federal benefits under the extended UI program. Forty-two states now require a one-week waiting period for regular UI benefits; the remaining states have no waiting requirement.

If all jobless workers were required to wait two weeks before receiving UI benefits, program outlays would be reduced, and beneficiaries in all states would be treated uniformly. Such a change would not affect the maximum length of time during which workers could collect benefits--for example, a person otherwise eligible for 26 weeks of benefits would retain that level of benefits but would receive payments during weeks 3 through 28 of joblessness. Benefits would be reduced, however, for those not using the maximum number of covered weeks. If implemented in 1987--after allowing time for states to change their UI laws--this option would cut total UI outlays by $3.6 billion between now and 1990.

This option could significantly reduce the work disincentive of UI by increasing the initial cost of being unemployed, yet it would not greatly affect the program's ability to help the long-term unemployed. This restriction of aid, in turn, might lower the number of workers who apply for assistance, in addition to reducing the duration of benefits paid to many who do apply.

On the other hand, because this change would reduce the benefits provided to jobless workers who do not use all of their entitlement, it would diminish the income support feature of UI. It would also impose additional federal restrictions on state UI programs, a move some oppose since state UI taxes finance regular UI benefits. Because UI is at least partially an insurance program rather than a welfare program, some also maintain that workers are entitled to benefits when they are unemployed and that extending the waiting period would be unjustified.

ENT-18 INDEX THE UNEMPLOYMENT INSURANCE TAXABLE WAGE BASE

	Annual Added Revenues (millions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	--	400	850	1,300	1,700	4,250

NOTE: These estimates assume that the change is implemented in January 1987, to allow time for changes in state laws. Further, some states with Unemployment Insurance programs in good financial condition are assumed to offset increases in the tax base with reductions in their tax rates.

The joint federal/state Unemployment Insurance (UI) program is financed primarily through payroll taxes on employers. The federal UI taxable wage base--which also serves as the minimum base for state UI taxes--is currently $7,000 per worker and has been increased only three times from its level of $3,000 in 1940. The proportion of wages subject to the federal tax has since fallen from over 90 percent to about 40 percent. In contrast, UI benefits have increased automatically with nominal wages, because benefits are based in part on prior earnings and because many states index their maximum weekly benefit to average weekly wages. Indexing the federal UI wage base by linking it to average earnings in the national economy--as is done with the Social Security base--would increase revenues, and reduce the federal budget deficit, by about $4.3 billion over the 1986-1990 period.

This option could help to stabilize the long-term financial position of the UI system by allowing revenue increases to follow a path similar to benefit gains. It could also allow for reductions in state tax rates, which have risen from an average of 1.3 percent of taxable wages in 1970 to about 2.8 percent in 1983. Finally, by concentrating the tax increase on the wages of workers now earning more than the current tax base, this change would make the UI tax somewhat more progressive.

Because this change could result in higher labor costs for employers, however, it might adversely affect employment levels. In addition, mandating increases in minimum wage bases for state UI taxes would limit somewhat the flexibility of states in designing tax systems to finance their UI benefits, although states in good financial condition could offset this change by lowering tax rates.

ENT-19 REDUCE GUARANTEED STUDENT LOAN SUBSIDIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Raise Students' Interest Rates						
Budget Authority	--	25	125	280	460	890
Outlays	--	15	95	235	415	760
Eliminate In-School Interest Subsidies						
Budget Authority	-105	450	790	960	1,020	3,115
Outlays	-55	310	700	915	1,000	2,870
Reduce Lenders' Subsidies						
Budget Authority	20	60	85	100	105	370
Outlays	10	50	80	95	105	340

Postsecondary students borrowing money under the Guaranteed Student Loan (GSL) program repay their loans after leaving school at interest rates between 7 percent and 9 percent--well below interest rates for unsecured personal loans. The federal government guarantees the loans, which lending institutions provide, and pays the interest while students are enrolled in school. In addition, during the entire life of the loan, the government pays lenders a variable amount that supplements students' interest, guaranteeing a return to lenders equal to 3.5 percentage points above the bond equivalent rate for 91-day Treasury bills.

The Congress could reduce federal spending on student loans in several ways. For example, students' subsidies could be reduced by requiring that they repay their loans at higher interest rates or by eliminating the in-school interest subsidy. Alternatively, the yield provided to lenders could be lowered. These options are discussed below.

Raise Students' Interest Rates or Eliminate In-School Interest Subsidies. Raising students' interest rates, after they leave school, to the full interest the government now pays to lenders would reduce federal spending by $760 million during the five-year period 1986-1990 and by more in future years.

Eliminating the federal subsidy for students' interest while they are in school, but continuing the other federal subsidies, would reduce federal outlays by $2.9 billion between 1986 and 1990. Both estimates assume that the options would affect only new loans and that the number of borrowers would continue at the level now expected. If some students were to drop out of the program, federal savings would be greater.

Proponents argue that even a 9 percent loan with no payments until students leave school is more highly subsidized than is necessary to encourage students to obtain further education. Both options would reduce the subsidy by requiring students to repay larger amounts. Letting students borrow the "in-school" interest at the time loans are made would give banks a similar yield as now, but borrowers would still not have to make any payments while attending school. Raising interest rates after students leave school would generally require smaller repayments than would eliminating the in-school interest subsidy.

Opponents of these changes--especially of the option to eliminate the in-school interest subsidy--argue that the increased costs would cause some students to leave school or to choose different institutions, and would result in large debt burdens for many students. Moreover, some lenders might drop out of the program because of somewhat increased servicing costs and complexity, thereby making it more difficult for some students to obtain loans.

Reduce Lenders' Subsidies. Reducing lenders' subsidies would lower program expenditures while not affecting students' costs. One approach would be to lower the interest supplement paid to lenders while students are in school, when lenders' servicing costs are lowest. As illustrated in the table above, each reduction of one-half of a percentage point in the yield on new loans while students are still in school would lower spending by $340 million during the next five years.

Current GSL subsidies may be higher than necessary to induce lenders to participate in the GSL program because the federal government bears all risk of rising interest rates and insures the loans against default. On the other hand, reducing the current subsidy could cause some lenders to stop providing GSLs and thus make loans more difficult for students to obtain. The effect would probably differ across the country, however, depending on the response of local lenders.

ENT-20 REDUCE SUBSIDY FOR NONPOOR CHILDREN IN CHILD NUTRITION PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	250	270	280	300	320	1,420
Outlays	250	270	280	300	320	1,420

Federal child nutrition programs provide cash and commodity assistance to schools and other institutions that serve meals to children. In the largest such program, the National School Lunch program, for example, most schools receive $1.26 in cash reimbursement for each meal served to children from households with incomes at or below 130 percent of the poverty line; a reduced subsidy of 86 cents for meals served to children from households with incomes between 130 percent and 185 percent of poverty; and a subsidy of 12 cents for children with household incomes above 185 percent of poverty. Schools are also given 12 cents' worth of commodities for each lunch served, regardless of household income. Comparable reimbursement structures are used in the School Breakfast program and in part of the Child Care Feeding program.

Eliminating cash reimbursements for meals served to children from households with incomes over 185 percent of the poverty line ($18,870 per year for a family of four in the 1984-1985 school year) would reduce federal expenditures by about $250 million in 1986, and about $1.42 billion over the 1986-1990 period. These estimates assume that all participating schools would remain in the program. With lower total subsidies, however, some schools might judge that the federal reporting requirements and restrictions on meal composition were too burdensome to make participation worthwhile, especially if few children remained eligible in the free and reduced price categories. Decreased school participation would increase budgetary savings, as fewer children and schools would receive subsidies.

Proponents argue that reimbursements for meals served to nonpoor children provide subsidies to families who do not need such assistance, and that this change would target nutritional aid toward those most in need.

Opponents argue that meals qualifying for reimbursement are nutritionally superior to those from alternative sources, and eliminating subsidies for nonpoor students could result in lower-quality meals for those children. They also maintain that the participation of nonpoor children in the program helps schools hold down their overall per-meal preparation and service costs. Eliminating the cash subsidy, they argue, might reduce participation of nonpoor students, prompting some schools to opt out of providing the service--thereby denying reduced-price or free meals to low-income children.

ENT-21 TERMINATE OR RESTRICT ELIGIBILITY FOR GENERAL REVENUE SHARING

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Terminate GRS						
Budget Authority	4,550	4,800	5,000	5,250	5,550	25,150
Outlays	3,450	4,750	4,950	5,200	5,450	23,800
Restrict Eligibility and Reduce Funding						
Budget Authority	1,350	1,450	1,500	1,600	1,650	7,550
Outlays	1,050	1,400	1,500	1,550	1,650	7,150

The General Revenue Sharing (GRS) program, established in 1972, provides unrestricted grants totaling $4.6 billion annually to all local governments--counties, municipalities, townships, and Indian tribes. State governments also participated until 1981, when their share was eliminated on the ground that their fiscal condition no longer warranted federal subsidies. Substantial federal savings could be realized either by eliminating the GRS program or by restricting eligibility to exclude communities in good fiscal condition and, at the same time, reducing funding levels.

Terminate GRS. If General Revenue Sharing were eliminated, federal savings would total $23.8 billion over the 1986-1990 period. Proponents of terminating the program argue that, under current economic circumstances, federal aid should be targeted toward programs with clear national policy objectives rather than toward programs such as GRS that place no restrictions on expenditures. They argue further that since GRS payments represent less than 2 percent of total revenues of local governments, the impact on local fiscal conditions would be moderate.

Restrict Eligibility and Reduce Funding. Eligibility requirements could be changed to exclude communities in relatively strong fiscal conditions. Such governments could be identified by their relatively low tax efforts or relatively high capacity to support services. Alternatively, state governments could be invited to submit proposals for identifying distressed communities and ways to distribute aid among them. Those who favor terminating funding to fiscally sound communities might argue that limited federal resources should be targeted toward areas with the least capacity to help themselves, and that no national goals are served by subsidizing well-off jurisdictions with general-purpose grants. By limiting eligibility to financially pressed localities and cutting overall funding by 30 percent, the federal government would save $7.2 billion over the five-year period.

Advocates of maintaining the status quo would argue that, over the last decade, GRS has been figured into the budgets of its recipients, and ending that support could impose at least temporary stress on some governments, particularly in view of cutbacks in other federal assistance programs. Indeed, some argue that the "no strings attached" nature of GRS makes it a model for federal assistance and that categorical aid programs are the ones that should be pared. Opponents of the modified option of eliminating funding only for jurisdictions with strong fiscal conditions would argue further that the formula determining GRS allocations already takes into account jurisdictions' fiscal conditions, so that better-off jurisdictions receive less than other localities anyway.

ENT-22 REDUCE AND RETARGET AID FOR DEPENDENT CARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Gross Revenue Gain	110	1,050	1,200	1,350	1,500	5,210
Outlays a/	-55	-525	-600	-675	-750	-2,605
Net Savings	55	525	600	675	750	2,605

a. Negative numbers reflect increased outlays for the SSBG (see text).

The federal government provides financial support for dependent care through the Dependent-Care Tax Credit and the Social Services Block Grant (SSBG). The tax credit permits taxpayers to claim a specified percentage of employment-related expenses for care of children under age 15 and certain other dependents. The credit is granted on a sliding scale--30 percent of up to $4,800 in allowed expenses for taxpayers with adjusted gross incomes of $10,000 or less, declining gradually to 20 percent for those with incomes above $28,000. The SSBG funds a wide variety of social services, including day care for children and other dependent people.

Federal support could be retargeted toward those most in need--while reducing the deficit--by tightening the tax credit and expanding the SSBG, with the stipulation that the additional funds be used to provide dependent care to low-income families. The tax credit could be more steeply graduated, declining by 1 percent per $1,000 of adjusted gross income over $10,000 (the present reduction is 1 percent per $2,000), phasing out for those with an adjusted gross income above $39,000. If half of the savings were applied to the grant program, net savings would be $55 million in 1986, and $2.6 billion over the 1986-1990 period.

This option would help meet the growing need for dependent-care services for low-income families. About 5.2 million children under age 6 lived in poverty in 1983--an increase of almost 2 million since 1979--and nearly half lived in single-parent households headed by a woman. The families of these children have difficulty obtaining high-quality child care without assistance, and because of their low incomes, few benefit from the tax credit. This option would also remove work disincentives for some low-income parents.

On the other hand, these measures would require a partial reversal of some recent changes in federal support for dependent care. In creating the SSBG in 1981, the Congress removed the requirements of the predecessor program (Title XX) that benefits be targeted by income and that a specified amount of funding be spent on child care. The restricted eligibility for the credit, moreover, would adversely affect some families with higher incomes whose tax liabilities would be raised by the tightening of the tax credit.

AGRICULTURAL PRICE SUPPORTS

This category presents four options for reducing agricultural price-support outlays. Three options deal with crop programs and one covers the dairy price-support program. AGR-01 would provide mandatory production controls for major ~~crops~~, transferring the costs of supporting farm incomes from taxpayers to consumers. The other options generally emphasize a lower level of price and income support that would be consistent with market-oriented policies. AGR-02 would reduce income support to large-scale farms by lowering the amount of government payments that individual producers can receive. AGR-03 would emphasize price stability with market-sensitive price supports and a phaseout or elimination of deficiency payments. AGR-04 would orient the dairy price-support program toward price stabilization through reductions in the price-support level.

AGR-01 STRENGTHEN CROP PRICES WITH MANDATORY PRODUCTION CONTROLS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	820	3,150	4,350	5,850	6,600	20,800
Outlays	820	3,150	4,350	5,850	6,600	20,800

Under current law, the Secretary of Agriculture can restrict feed grain, wheat, cotton, and rice production by withholding program benefits from farmers who do not reduce planted acreage, and by paying farmers for diverting acreage. These voluntary acreage reduction programs, while consistent with the long-term objective of giving farmers greater freedom in managing their businesses, are of limited effect. An alternative would be to legislate mandatory acreage reduction and marketing quotas for the 1986-1989 crops. One option would be to restrict output sufficiently to keep commodity stock levels down to more reasonable levels, thereby raising prices and reducing deficiency payments and loans. The estimated savings would be $3.2 billion in 1987 and $6.6 billion in 1990.

Supporters base their case for mandatory controls on the poor intermediate-term outlook for exports of these major crops. This implies relatively weak crop prices, resulting in large price-support outlays. Mandatory production controls would help to keep supplies in balance with expected demand and desired stocks, thereby strengthening crop prices and reducing outlays for farm programs. Control levels could be adjusted annually in response to expected supply-demand conditions. But import controls might also be needed for an effective program, depending on the course of prices abroad.

By raising prices, mandatory controls would transfer the costs of supporting farm incomes from taxpayers to consumers, here and abroad. Domestically, prices would rise most for meat, poultry, and dairy products because of higher feed grain prices. Bakery and cereal product prices would be less affected. While mandatory controls would increase farm income in the intermediate term, the long-run effect is uncertain. Other exporting countries would very likely increase their production and undercut U.S. sales abroad. In addition, industries selling to agriculture would lose sales. In the past, the farm income benefits of crop restriction programs have been capitalized into farmland prices, benefiting landowners of whom many are not farmers. Mandatory controls would also sharply increase government intervention, thereby reversing the long-term trend toward a more market-oriented agriculture.

AGR-02 LIMIT INCOME ASSISTANCE TO LARGE-SCALE CROP FARMS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	0	1,100	1,050	950	900	4,000
Outlays	0	1,100	1,050	950	900	4,000

Current crop price-support programs benefit primarily large-scale commercial farmers since government payments are in proportion to production. An alternative would be to put a limit on such benefits to large-scale farmers. This could be done under existing programs by limiting the dollar amount of government payments an individual may receive annually, or by restricting the acreage eligible for payments. One option would be to hold deficiency payments and acreage diversion payments to $10,000 per individual as compared with the current $50,000 limit. If this was first applied to 1986 crops, annual outlay savings over the 1987-1990 period would average $1 billion, producing cumulative savings of $4 billion over the period.

Proponents point out that large crop farms generate much higher than average incomes so that these farmers do not need income assistance; it is the small and medium-size farms that most need income support. This option would reduce income transfers to the largest farms, especially those producing cotton and rice. Many farms would not be affected much by a $10,000 payment limitation, since they would receive about the same income support as currently.

This approach would not be very effective for targeting income support to farmers with the greatest need. Critics of this proposal suggest that farm size is a poor way of determining farmers with economic need since there is great diversity among crop farmers' incomes. Further, under current law deficiency payments are often an incentive for farmers to reduce acreage. A lower payment limit would likely discourage some producers from voluntarily reducing acreage, thereby reducing the effectiveness of supply management. Lastly, farms can be redefined so as to make more individuals eligible for payments, thus reducing outlay savings.

AGR-03 REDUCE THE PRICE-INCREASING FEATURES OF MAJOR CROP PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Elimination of Deficiency Payments						
Budget Authority	730	5,900	7,600	7,500	7,200	28,900
Outlays	730	5,900	7,600	7,500	7,200	28,900
Phased Elimination of Deficiency Payments						
Budget Authority	730	280	2,900	6,500	7,000	17,400
Outlays	730	280	2,900	6,500	7,000	17,400

Current crop programs raise the prices of wheat, corn and other feed grains, rice, and most U.S.-grown cotton to higher levels than these commodities would command without government intervention. An alternative is to change price-support programs to emphasize year-to-year stability in commodity prices rather than raising their long-term level. Three key features would characterize such a policy shift: price supports and ceilings that changed in response to shifting market conditions; less reliance on government stockpiling of surpluses; and eliminating or phasing out so-called "deficiency payments" that compensate farmers when crop prices fall below target prices. Also, acreage reductions would be eliminated. If first applied to 1986 crops, the elimination of deficiency payments would give annual average outlay savings over the 1986-1990 period of $5.8 billion, producing cumulative savings of $28.9 billion over the same period. Savings from a phased-in elimination of deficiency payments would total $17.4 billion over 1986-1990.

Current programs provide benefits in direct proportion to volume produced, benefiting mainly the owners of large farms. These large commercial farms are a small minority of the nation's farms and most are operated by families whose average incomes are well above average nonfarm family incomes. Moreover, by artificially raising prices these programs discourage foreign consumption of U.S. farm products and create burdensome surpluses and excessive federal outlays. Crop farmers would benefit from more stable commodity prices. Their dependence on volatile export markets has made them highly vulnerable to uncertain prices and incomes. Livestock producers and consumers would also benefit from more stable commodity prices. Shifting to a policy that emphasized stabilizing prices rather than increasing incomes would cause farmers a short-term income loss, but the loss might to some extent be offset by increased exports.

A stabilization policy would tend to lower farm prices, but this initial short-run impact would be mitigated in the longer run as production and exports responded. Critics point out, however, that a policy shift toward price stabilization would expose farmers to income losses. Many have suffered several years of financial stress; a reduction in federal support would probably mean reduced incomes for farmers and further declines in their asset values. There would be some shift of people and resources out of farming and into other occupations. Moreover, implementation of a price-stabilization policy would be difficult; program managers would have to estimate trends in prices and production in inherently volatile markets.

AGR-04 REDUCE PRICE SUPPORTS IN THE DAIRY INDUSTRY

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	250	490	710	860	680	3,000
Outlays	250	490	710	860	680	3,000

The cost of the dairy price-support program to taxpayers is estimated at $2 billion in 1985, down 20 percent from the record $2.5 billion in 1983, but still representing government purchases of 7 percent of U.S. milk production. The government buys surplus milk in the form of manufactured dairy products at a current support price of $12.60 per hundredweight (cwt). Under a paid diversion program that began January 1, 1984, and will expire March 31, 1985, the government also pays $10.00 per cwt to dairy farmers for reducing production below a base level. All dairy farmers--whether or not they reduce production--must pay the government an assessment of $0.50 per cwt for milk they sell. When the diversion program ends, the Secretary of Agriculture is authorized to reduce the support price to $12.10 if expected government purchases in the period from April 1, 1985, to March 31, 1986, exceed 6 billion pounds. But since the assessment will also end, the effective support price will not change. Milk production and price-support outlays are expected to increase after the diversion program ends; the support price along with relatively low grain prices will encourage some farmers to increase herds and output per cow. An additional $0.50 per cwt cut in the support price could be made on July 1, 1985, if expected purchases for the next 12 months exceed 5 billion pounds.

One option would be to reduce the support price further to $11.60 per cwt on April 1, 1985, and to $11.10 per cwt on October 1, 1985. Other reductions in the support price would follow on an annual fiscal year basis until projected government purchases fell to about 2 percent of annual milk production. If the support price was lowered as in the option described above, the estimated savings in 1986 would be $250 million, rising to $680 million in 1990.

The case for reducing the level of milk price support is based on the belief that the program has increased dairy farmers' incomes at the expense of taxpayers. Price supports could be used to reduce some of the price volatility in the industry, which would benefit both farmers and consumers. But the level of support in recent years has been so high relative to milk production costs that dairy farmers have produced for the government rather than the market.

The case against reducing the dairy price-support level is that dairy farmers would experience a loss of income. Some with low incomes and high indebtedness would probably go out of business sooner than they might otherwise. For several reasons, many dairy farmers have few employment alternatives. Also, a reduction in milk production would adversely affect processing firms that have expanded their capacity for the purpose of selling manufactured dairy products to the government. In short, the adjustment to a stabilization policy for the dairy industry would harm some dairy farmers and processing firms.

NONDEFENSE DISCRETIONARY SPENDING

This category presents 26 options for reducing nondefense discretionary spending. The options cover a very diverse set of programs, mirroring the variety of nondefense discretionary spending activity. NDD-01 through NDD-03 represent possible changes in international affairs spending. NDD-04 discusses reducing spending for NASA's space shuttle. NDD-05 through NDD-09 involve reductions in spending for natural resources programs, while NDD-10, NDD-11, NDD-18, and NDD-19 discuss options concerning community, regional, and business development. NDD-12 through NDD-17 present alternatives to reduce spending for transportation programs. Options NDD-20 through NDD-25 concern human resources programs, and NDD-26 lowers spending for the administration of justice.

The options presented are illustrative; they in no way represent a comprehensive review of nondefense discretionary spending. The estimated savings from the options should be compared with baseline nondefense nondiscretionary spending--$182 billion in 1986--and to the deficit--projected to be $215 billion in fiscal year 1986 (including on- and off-budget spending). Thus, for example, a 1986 savings of $1.82 billion would represent a one percent cut in total nondefense discretionary spending and a slightly less than one percent reduction in the deficit.

Much spending in this area is for salaries, administrative expenses, and construction purchases. Many of the options in the next category--Federal Personnel, Management, and Construction--would both reduce overall nondefense discretionary spending and correspondingly reduce the savings associated with particular options presented here. Similarly, some of the options in this category overlap with one another; reducing the number of veterans eligible for VA hospital care would, for example, limit the savings from requiring copayments from VA hospital patients (see NDD-24 and NDD-25).

All savings estimates presented are relative to the CBO baseline, which assumes that nondefense discretionary spending will remain constant when adjusted for inflation.

NDD-01 END THE EXPORT-IMPORT BANK DIRECT LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	3,450	3,200	3,250	1,950	2,150	14,000
Outlays	320	1,150	1,690	1,950	2,000	7,110

The Export-Import Bank (Eximbank) promotes U.S. exports by providing loans and loan guarantees to foreign purchasers of U.S. goods. The direct loan program offers subsidized interest rates, while the loan guarantee program encourages commercial banks to extend credit to foreign buyers by reducing the risk inherent in export financing. Since the mid-1970s, roughly two-thirds of Eximbank credits have fostered the purchase of aircraft and electrical power plant and equipment. Annual Eximbank loans are projected to rise from $3.8 billion in 1986 to $4.8 billion in 1990. Eliminating the direct loan program would save $320 million in outlays in 1986 and $7.1 billion over the entire five-year period.

Supporters of the Eximbank direct loan program argue that it is necessary to offset the subsidies other nations provide for their exports. They also claim that these exports create employment in the exporting industries. Moreover, proponents contend that exports allow some U.S. high technology industries to maintain a high level of output and, consequently, advance technologically.

Critics of Eximbank's direct loan program claim that these justifications are overstated. The amount of extra employment resulting from Eximbank's program is open to question. Current analyses suggest that many exports financed by Eximbank would have been sold in any event. Thus rather than creating employment, these loans merely transfer funds from U.S. taxpayers to domestic producers and foreign purchasers. Further, even when the program results in more exports, the overall impact on U.S. employment is unclear. Given flexible exchange rates, the increase in employment in the export industry may be offset by decreases in other industries. Therefore, more direct methods of advancing technology and increasing employment are likely to be more cost-effective. Finally, some critics suggest that Eximbank subsidized loans might be used as part of counter-trade agreements--that is, foreign buyers would purchase U.S. exports in exchange for U.S. buyers importing goods from the nation in question. If this is the case, the contribution of Eximbank to net exports would be significantly reduced, if not eliminated.

NDD-02 REDUCE FUNDING FOR THE ECONOMIC SUPPORT FUND

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	400	420	430	450	470	2,170
Outlays	230	290	350	390	420	1,680

The Economic Support Fund (ESF) extends economic assistance to nations of political and strategic interest to the United States. Some 43 nations currently receive ESF funding, with nearly half the aid going to Israel and Egypt. Fund disbursements constitute some 40 percent of U.S. nonmilitary economic aid to foreign nations. The program has grown rapidly in recent years, rising from $1.9 billion in budget authority in 1980 to $3.8 billion in 1985. This upward trend could be reversed, however, and ESF funding cut by 10 percent. Resulting outlay savings would come to $230 million in 1986 and $1.7 billion over the 1986-1990 period.

Critics of this funding point to the ESF's failure to contribute to the economic growth and stability of recipient nations. Unlike aid provided through most other development programs, the bulk of ESF aid is extended unconditionally. Some argue that unless aid is tied to fundamental economic reform, it can perpetuate rather than mitigate the problems that gave rise to the need for aid. Indeed, these critics assert that, by supporting inefficient economic policies, the ESF has slowed development in some countries. To the extent that ESF funds do support economic development, it is argued that the same objectives could be achieved by working through multilateral development organizations, such as the World Bank, in which U.S. contributions would be matched by other industrialized countries.

Defenders of the program cite its value as an instrument of foreign policy. Any reduction of ESF funding, they note, could diminish U.S. influence abroad and, in some cases, create a risk to national security.

NDD-03 ELIMINATE CARGO PREFERENCE FOR NONMILITARY SHIPMENTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
On-Budget						
Budget Authority	150	160	160	170	170	800
Outlays	150	160	160	170	170	800
Off-Budget						
Budget Authority	50	50	50	40	20	210
Outlays	20	50	50	50	30	200

The federal government provides both indirect and direct subsidies to the U.S.-flag merchant marine--that is, vessels built, owned, and operated by U.S. firms and engaged in international trade. A major form of indirect aid is provided through so-called "cargo preference" legislation, which requires all U.S. military cargo and one-half of other government freight to be carried in U.S.-flag vessels. Most nonmilitary shipments consist of bulk cargo, including agricultural exports and shipments for the Strategic Petroleum Reserve (SPR). Because the average costs to build and operate U.S. vessels are some two to three times those for non-U.S. ships, this guaranteed market increases government shipping costs substantially. Thus, eliminating cargo preferences for nonmilitary shipments would reduce federal spending by about $170 million in 1986 and $1 billion over the 1986-1990 period. Of this sum, about one-fifth would be off-budget, since it is used to transport SPR oil.

Critics of the program believe it merely subsidizes inefficient carriers and raises government transportation costs. The loss of nonmilitary government cargo, however, would force some higher-cost U.S. vessels out of business, thus reducing somewhat military sealift capacity in a national emergency. This effect would probably be minor, since bulk cargo vessels, which are the main beneficiaries of cargo preference, cannot easily be adapted for military sealift.

The Maritime Administration also provides direct assistance--over $400 million in 1984--to U.S. shipping through subsidies that make up the difference between the operating costs of foreign and U.S. shipping. Some vessels receive subsidies under both the cargo preference and operating subsidy programs. As an alternative to changing cargo preference laws, this double subsidy could be eliminated, thus reducing the operating subsidy by perhaps $20 million a year and $125 million over the 1986-1990 period.

NDD-04 DECREASE FUNDING FOR THE SPACE SHUTTLE

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	260	260	260	270	280	1,330
Outlays	200	250	260	270	280	1,260

The space shuttle, operated by the National Aeronautics and Space Administration (NASA), is designed to service the space transportation needs of the U.S. government--NASA, other civilian federal agencies, and the Department of Defense--as well as private firms and foreign governments. The shuttle budget includes funds for operations, spare parts for the four current orbiters, other equipment, and construction of facilities. NASA is currently planning for a dramatic increase in the number of shuttle flights--from 4 in 1984 to 24 in 1989 and beyond.

Reducing NASA's operational budget for the space shuttle by 10 percent would slow this substantial planned increase in flights. By a conservative estimate, 15 of the 24 flights planned for 1989 still could be supported. (A 10 percent decrease in operating funds would lead to more than a 10 percent decrease in flights, because NASA estimates that two-thirds of its operational costs are fixed, regardless of the number of flights.) Such a change would save $200 million in outlays in 1986 and $1.3 billion over the 1986-1990 period, compared to the CBO baseline.

Proponents of such a reduction argue that NASA's planned flight rate is economically and technically unrealistic, and that this will lead NASA to spend too much on, and charge too little for, shuttle services. The flight rates projected by NASA could prove to be significantly above the actual demand for shuttle services. Past projections have consistently overestimated the demand for such services by both the government and the private sector. NASA has also consistently overestimated its technical ability to achieve a given flight rate. These two factors have led to spending more for hardware, launch and flight support, and research and program management services than was required. Lower flight rates and higher total costs have also led to a substantially higher than anticipated cost per flight. In turn, this has led to charging foreign and commercial users too little. Because the price that these users pay must be agreed upon far in advance, it cannot be adjusted later to reflect the actual costs incurred.

On the other hand, the shuttle system represents a large public investment that has just begun to pay off. As noted above, the ratio of fixed to operating costs is very high, and therefore a disproportionate increase in services can be obtained with a relatively small percentage increase in costs. Some would argue that it would be wasteful not to exploit these economies of scale. Furthermore, actual experience in operating the shuttle might have made current cost and flight rate projections more accurate than those made in the past. NASA might, therefore, be more likely in the future to realize its goal of recovering costs from the Department of Defense and from foreign government and commercial users. Finally, because NASA projects the price it charges foreign and commercial customers to exceed the cost of providing flight services, the budgetary savings of lowering the flight rate would be realized only if the U.S. government were to cut back its own flights rather than those supplied for foreign and commercial customers.

NDD-05 REDUCE SUBSIDIES FOR THE RURAL ELECTRIFICATION ADMINISTRATION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Net On- and Off-Budget Savings a/						
Budget Authority	10	120	220	310	340	1,000
Outlays	10	120	220	310	340	1,000

a. Although the REA fund is off-budget, its financing transactions appear both on- and off-budget. The net savings from this option would appear in the on-budget accounts.

The Rural Electrification Administration (REA) was created in the 1930s to ensure that rural cooperatives could obtain the financing needed to establish utility service in rural areas. In 1973 the Congress set up the Rural Electrification and Telephone Revolving Fund to provide direct loans to rural utility cooperatives at an interest rate of 5 percent. At that time, this rate was about 1 percent below the then prevailing long-term Treasury borrowing rate. In recent years, however, the gap between the 5 percent rate paid by cooperatives and the REA's cost of borrowing has grown to nearly 7 percent, making this one of the most steeply subsidized federal credit programs.

Because of this interest subsidy, the REA fund is on a path toward insolvency. It makes about $1.1 billion each year in new direct loans at the 5 percent interest rate and finances about 40 percent of them by borrowing from the Federal Financing Bank (FFB) at prevailing Treasury interest rates (averaging about 11.4 percent in 1984). The REA must finance this large proportion of its loans through the FFB because the lending levels required by the Congress are 250 percent higher than REA's income from loan repayments. Interest losses on the loans have eroded the fund's income to the point that the fund will not have sufficient income to repay the $7.9 billion owed to the Treasury for loans made before 1973. In 1984 and 1985, the Congress appropriated more than $200 million to defray such interest losses, but even with continued appropriations, the fund is in danger of defaulting on some of its obligations to the Treasury, as well as to the FFB. Under these circumstances, it will be necessary in the future to reduce lending, to appropriate even greater amounts, or to generate additional income from loans to cooperatives in order to meet the fund's obligations.

To ensure the fund's solvency, the Congress could raise the interest rate on new loans and increase cooperatives' reliance on private-sector financing. Charging the Treasury interest rate on new loans and reducing federal lending by 25 percent (from $1.1 billion to $825 million) would ensure the solvency of the fund and reduce federal outlays by about $10 million in 1986 and $1 billion over the 1986-1990 period.

Increasing the fund's interest income through higher rates would eliminate the need for continued appropriations and ensure that the REA could fulfill its obligations to the Treasury and the FFB. Charging the Treasury interest rate for direct loans would reduce net federal outlays by $0.2 billion over the 1986-1990 period, and by substantially increasing amounts in the 1990s. Alternatively, if the interest rate were set below the Treasury rate but at a level sufficient to maintain a prudent balance between the fund's interest expense and interest income, the federal government could save $0.1 billion over the five-year period. Under this alternative, standard loans would bear interest at a rate about 2 percent below the Treasury rate, assuming long-term Treasury rates averaging about 10.2 percent during the next five-year period. The savings to the government would increase significantly in the 1990s as more of the outstanding loans bear interest at the higher rates.

Reducing the amount of federal lending by 25 percent would reduce federal outlays by about $0.8 billion over the 1986-1990 period. This reduction could be achieved either by revising loan eligibility criteria or by imposing more stringent matching requirements for private financing to reflect more exactly the rural character of cooperatives' service areas and their ability to secure private financing.

Proponents of such changes note that raising the interest rate to the full Treasury borrowing rate would still provide subsidies to the rural cooperatives over the borrowing costs they would face in the private financing market. They also argue that REA's current practice of lending money without regard to a cooperative's financial condition or rural character provides a windfall to some cooperatives. They finally claim that the need for any further subsidies is unclear, since the original goals of the program have largely been met. Opponents of reducing the REA loan subsidy contend that it might raise power rates in many rural regions, although the actual rate increases are likely to be less than 1 percent through 1990.

NDD-06 RESCHEDULE TREASURY PAYMENTS BY THE BONNEVILLE POWER ADMINISTRATION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	50	50	40	40	40	220
Outlays	330	300	290	280	270	1,470

The Bonneville Power Administration (BPA), a federally sponsored utility, markets its electric power in the Pacific Northwest. Its operating expenses are financed through charges to its ratepayers. Capital investments for generation facilities are financed by federal appropriations at subsidized interest rates averaging 3 percent. Transmission and conservation investments are also financed by borrowings from the Treasury, although they must be repaid at the same rate as the government's cost of borrowing. Federal investment in all BPA facilities totaled about $7.8 billion by the end of 1983. The BPA is required by law to repay all federal investments within a "reasonable period" through income from electricity sales.

The BPA experienced unanticipated revenue shortages in the last decade. Because Treasury repayments are the first to be deferred when revenues are insufficient to meet all obligations, the BPA has fallen behind its planned repayments to the U.S. Treasury. Its cumulative repayments would have been about $1.1 billion more since 1974 had the BPA adhered to a fixed (mortgage-like) repayment schedule. Similarly, if all federal investments had been repaid at the Treasury interest rate, BPA's interest payments would have been $2.8 billion more over the 1974-1984 period.

Requiring the BPA to repay all federal investments according to a fixed payment schedule at current Treasury interest rates (about 8.5 percent for one-year notes) would reduce federal outlays by $330 million in 1986 and $1.5 billion in the 1986-1990 period. A similar approach has worked well for repaying federal investment in the Tennessee Valley Authority power system. These changes, however, could increase electrical rates for BPA's consumers--on average, about 11 percent--bringing them up to about half of the national average.

As an alternative, federal investments could be repaid on a fixed schedule, but bear interest at the Treasury rate that was applicable in the year the facilities went into service (the weighted average interest rate for this alternative would be less than 7 percent). This option would lead to somewhat smaller increases in consumer electrical rates than under the first alternative. Such an approach would reduce federal outlays by about $1.0 billion over the 1986-1990 period.

NDD-07 ELIMINATE COMMERCIALLY ORIENTED ENERGY DEVELOPMENT

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	790	790	830	870	910	4,190
Outlays	340	640	800	840	890	3,510

The Department of Energy (DOE) supports research and development in alternative energy sources that could reduce U.S. dependence on imported oil. Funded activities include both commercially oriented technological development and longer-term basic research in the areas of nuclear fission, fusion, fossil fuels, solar, geothermal, and conservation. Nearer-term federal development projects seek to promote the commercialization of alternative energy sources through prototype construction and other demonstration work. Eliminating federal funding of all commercial development programs could save $340 million in outlays in 1986 and $3.5 billion over the 1986-1990 period.

Elimination of commercial energy development funding would accelerate the Administration's stated goal to place greater reliance on the private sector to support technological development. Eliminating this funding would allow the private market to determine which new energy technologies would be commercialized and how fast this process would occur. Such a policy would be successful to the extent that the market is more proficient than DOE in choosing and financing the most promising alternative energy technologies. Further, such activities might be more appropriately carried out by the private sector, in light of the significant efforts the federal government has already made in this area as well as the improved outlook for stable oil prices.

Supporters of DOE's commercial development efforts argue that the reduction of U.S. dependence on imported energy sources remains an important policy goal. If the recent moderation in oil prices is only temporary, alternative energy sources, which are currently more expensive, might again become important. Continued government support of alternative energy technologies might be necessary to hedge against future price shocks or supply disruptions, especially considering waning private-sector interest in alternative fuels under current price conditions. Moreover, in the long run, alternatives will be required to compensate for the gradual depletion of domestic oil and gas.

NDD-08 REDUCE SUPPORT FOR INLAND WATERWAYS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	360	370	380	400	410	1,920
Outlays	350	360	370	390	410	1,880

In 1985 the Army Corps of Engineers will spend about $660 million on the maintenance, rehabilitation, and construction of the nation's system of inland waterways. About $300 million is for maintenance and operation of locks and canals and $360 million for construction projects approved more than 10 years ago. No new construction projects have been authorized since 1974, pending efforts to improve cost recovery on the waterway system.

Fuel taxes of 4 cents a gallon were imposed on barge transport for the first time in 1981; they will rise to 10 cents a gallon by 1986. Even so, receipts will recover only 10 percent of spending on the inland waterway system over the 1986-1990 period, leaving net federal spending at about $3.4 billion. Eliminating projects to enlarge the system's capacity and retaining only those programs needed to operate existing canals, locks, and dams would save $350 million in outlays in 1986 and $1.9 billion over the five-year period 1986-1990.

Proponents of such a cut argue that capital expansions are unnecessary. They cite as evidence the overcapacity in the barge industry--about half the fleet is now idle--as well as the unwillingness of barge operators to pay for the projects through higher user fees.

A virtual elimination of capital spending by the Corps of Engineers would force barge operators and shippers to undertake any capital improvements themselves or support higher user fees to finance work by the Corps. Opponents of such a proposal point to the difficulties inherent in private development of facilities jointly used by competing companies. They argue that, should the industry rebound, there might be no effective way of ensuring that desirable capital improvements would be made.

NDD-09 ELIMINATE FEDERAL MAINTENANCE ASSISTANCE FOR DEEP DRAFT PORTS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	440	460	470	490	510	2,370
Outlays	430	450	460	480	500	2,320

The Corps of Engineers spends around $500 million a year to maintain channel depths at more than 200 ports nationwide. Port users benefit directly from this program both through the savings from shipping in larger vessels and by being able to minimize inland transport costs. Eliminating federal maintenance assistance would produce outlay savings of $430 million in 1986 and $2.3 billion over the 1986-1990 period.

At large ports the dredging cost per ton of cargo amounts to only a few cents; at small ports it is commonly in the hundreds and sometimes thousands of dollars per ton, well above any transport cost savings and sometimes even exceeding the cargo value. This free dredging diverts cargo from ports with natural deep water to ports that shippers would otherwise find too expensive to use. Forty-five ports with channels maintained by the Corps handle no cargo at all. Eliminating federal aid would force ports either to impose their own user fees or to seek local subsidies. The role of the Corps could be limited to that of a paid dredging contractor (in competition with others). This would limit demands for its services to ports whose users pay and to depths consistent with port users' needs.

Those in favor of continuing the Corps' current role in maintaining ports argue that many small ports might forgo maintenance dredging or perhaps close entirely, which would result in social and economic dislocations.

NDD-10 END DIRECT AND INDIRECT SUBSIDIES TO THE POSTAL SERVICE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
			End Direct Subsidies			
Budget Authority	790	830	860	900	930	4,310
Outlays	790	830	860	900	930	4,310
			End Indirect Subsidies			
Budget Authority	10	35	60	100	150	335
Outlays	220	400	460	690	670	2,440
			Total			
Budget Authority	800	865	920	1,000	1,080	4,665
Outlays	1,010	1,230	1,320	1,590	1,600	6,750

Direct and indirect subsidies to the U.S. Postal Service (USPS) allow postage rates to be set somewhat below the USPS's actual costs. Through appropriations to the USPS, the direct subsidy, called "revenue forgone," transfers to the taxpayers certain costs of postal services for preferred mail users--primarily religious and other not-for-profit organizations, blind and otherwise handicapped people, small-circulation newspapers, and libraries. Indirect subsidies take the form of partial taxpayer support of USPS retirees' pensions and health-care benefits, which are not fully covered by USPS and employee contributions. If both direct subsidies (except those for blind and otherwise handicapped people) and indirect subsidies were eliminated, the 1986 outlay saving would be $1.0 billion and five-year savings would be about $6.8 billion. The savings estimate for indirect subsidies would show up principally as higher offsetting receipts, which reduce outlays. The indirect subsidy estimate reflects a four-year phase-in and is limited to current postal workers who are not covered by Social Security and an as yet to be decided retirement plan. In addition, the estimate assumes the USPS would continue to make scheduled payments to the Civil Service Retirement fund.

Opponents argue that even phased-in elimination of all postal subsidies would force mail rates up and volume down. The CBO estimates that, without indirect subsidies, first-class rates to all mailers could eventually increase by roughly 5 percent; if both subsidies were eliminated, the cost of preferred-rate mail could rise by about 40 percent. Many would also contend that it is unfair to charge the USPS for the full cost of health and pension benefits when current law prohibits it from negotiating with labor on these issues.

With both subsidies eliminated and mailers carrying full postal-service costs, however, the USPS would move closer to self-sufficiency. Some analysts suggest that eliminating the subsidies would give the USPS an incentive to lower costs by improving management. Others have observed that direct postal subsidies fail to target federal expenditures toward specific national priorities, encourage "junk mail," and provide unnecessary support to many not-for-profit organizations. Moreover, subsidization might give the USPS an unfair market advantage over competing private-sector firms, leading to overuse of the USPS.

NDD-11 ELIMINATE NEW LENDING OR INCREASE HOMEOWNERS' PAYMENTS UNDER RURAL HOUSING LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Eliminate New Lending						
Budget Authority	0	0	380	580	800	1,760
Outlays	1,950	2,350	2,550	2,800	3,100	12,750
Increase Homeowners' Payments						
Budget Authority	-25	-45	220	310	390	850
Outlays	70	150	230	310	400	1,160

NOTE: Some of the outlay savings included here would appear off-budget.

The Section 502 program of the Farmers Home Administration (FmHA) currently provides mortgages at effective interest rates as low as 1 percent to enable low-income borrowers to purchase homes while spending only 20 percent of their incomes on mortgage payments, property taxes, and insurance. The FmHA's major cost is the difference between the rates it pays for the funds it borrows to finance the program and the rates paid by borrowers for its mortgages. During 1984 over 56,000 rural households purchased single-family homes with reduced-interest-rate loans from the FmHA--a very small proportion of those eligible for aid. Two approaches are considered for reducing federal costs under this program.

Eliminate New Lending. This option would end the deep subsidies provided to a relatively small number of households. Some critics argue that a program that makes such sizable payments to so few households is not the most defensible use of federal revenues. On the other hand, eliminating new lending under the Section 502 program would do away with a major tool that has enabled low-income rural households to become homeowners. Ending new lending would reduce federal outlays by about $2 billion in 1986 and $12.8 billion in the 1986-1990 period.

Increase Payments. This alternative would continue lending at the present volume, but raise the charges to borrowers. If, beginning in 1986, new FmHA borrowers paid 28 percent of their incomes for housing costs--the latest rate charged under a comparable Department of Housing and Urban Development program--federal outlays would be cut by $70 million in 1986 and $1.2 billion over the 1986-1990 period. On the other hand, increasing the percentage of income that rural households would pay toward mortgage costs could reduce the number of the very lowest-income households served and might increase mortgage defaults among program participants.

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NDD-12 REDUCE AND RETARGET AMTRAK SUBSIDIES

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	300	320	330	350	360	1,660
Outlays	270	300	330	340	360	1,600

Since 1971 Amtrak has received $9 billion in federal subsidies for its intercity passenger services. When it established Amtrak, the Congress thought it would need to provide support only for start-up costs. Instead, continued subsidies now total some $700 million a year, covering all capital spending and nearly one-half of operating costs. The changes suggested in this option would save $270 million in outlays in 1986 and $1.6 billion from 1986 through 1990.

Amtrak subsidies could be reduced and restructured to improve cost control and efficiency incentives while affording protection to towns that might otherwise be left without intercity transportation. The following measures would encourage such changes:

- Eliminate subsidies on the Northeast Corridor, saving $710 million from 1986 through 1990;
- Require that fares (or local subsidies) for each route cover at least all costs for crews, supplies, and fuel, saving about $790 million from 1986 through 1990; and,
- Eliminate subsidies for services to points that receive transport subsidies under the small-community air service grants, saving $100 million over the 1986-1990 period.

Proponents of reductions argue that the current subsidy provides little incentive to recover costs--even on the potentially profitable Northeast Corridor. Cutting all subsidies for these lines could therefore be particularly effective. (See Congressional Budget Office, *Federal Subsidies for Rail Passenger Service: An Assessment of Amtrak*, July 1982.) Further, raising fares on other lines would increase the possibility that competing bus or air services would become financially attractive and thus decrease the dependence of some small towns on Amtrak services. Finally, the third change listed above would eliminate duplication of federal programs supporting long-distance passenger transport.

Those opposed to cuts claim that reduced federal support might lead Amtrak to cancel service where the demand is low but where reliable year-round services are not provided by other kinds of transport. Furthermore, they claim that the integrated national network could be threatened by such cancellations. Any cancellations might also involve employee protection benefit payments, which would reduce the savings.

NDD-13 REDUCE FEDERAL MASS TRANSIT AID

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	1,950	1,990	2,040	2,060	2,030	10,070
Outlays	700	1,090	1,430	1,660	1,910	6,790

The federal government currently provides substantial support for mass transit through programs that support the capital and operating costs of most public transit systems. These programs, administered by the Urban Mass Transportation Administration, have grown dramatically since they were first instituted in the mid-1960s. Outlay savings of $700 million in 1986 and $6.8 billion over the 1986-1990 period could be obtained by reducing the federal match on capital grants from the current 75 percent or 80 percent to 50 percent and by eliminating operating assistance.

Supporters of such a reduction note that federal aid has allowed transit systems to finance large increases in costs--real unit labor costs increased 43 percent during the 1970s, for example--while ridership and fare collections declined. They also argue that the large federal subsidies for capital spending have encouraged local transit agencies to purchase new capital equipment, such as large buses and subways, rather than to improve the quality or productivity of existing services. Finally they assert that reduced federal operating and capital support would force local authorities to lower costs and increase ridership by making greater use of innovative techniques, including private contracting for services; use of more cost-effective smaller vehicles to meet the needs of special groups; direct subsidies for low-income riders (akin to food stamps); and reduced local regulations to permit private firms to compete directly with public transit agencies.

Proponents of federal transit aid claim that public transportation is essential to urban mobility and that sudden changes in financial assistance could cause dislocations and hardships for certain groups. Others argue that an across-the-board cut would be particularly inefficient in that the greatest need for large investments in transit improvement is now mostly confined to rehabilitating systems in older cities and that federal assistance should be targeted to such cities.

NDD-14 REDUCE AND REFOCUS HIGHWAY SPENDING

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	5,910	6,030	6,140	6,260	6,510	30,850
Outlays	990	4,110	5,170	5,640	6,030	21,940

The federal government, in partnership with the states, finances construction and repair of the nation's highways and bridges. The federal share was $10.2 billion in 1984--about one-third of total highway and bridge spending. For 1986 the Congress has authorized an increase in highway spending to $15.3 billion. Over the years, the federal-state partnership in financing the construction of highways has grown to include more locally oriented segments of the nation's road network, such as beltways and other local routes. As a result, today only two-thirds of federal highway funds are spent for the two most nationally oriented road systems (the Interstate and Primary systems), compared with 90 percent just 15 years ago. Over the 1986-1990 period, $21.9 billion dollars in outlays ($990 million in 1986) could be saved by limiting the federal highway program to its original emphasis on intercity arteries.

At present, locally oriented routes account for more than half of the spending needed to complete the remaining 1,500 miles of the Interstate system. Focusing federal dollars on Interstate routes of national significance would reduce outlays by $11 billion over the next five years alone. Returning financial responsibility to state governments for urban and secondary roads, for other noninterstate roads, and for local bridges would reduce federal spending by an additional $11 billion over the next five years.

Withdrawing federal support for such routes, however, would involve breaking long-standing commitments and would force either substantially greater state and local expenditures or the curtailment of some construction and repair work. The added burden on states could be reduced somewhat by providing them with a portion of the revenues from the recent increase in the federal motor fuels tax, but this would also reduce the federal budgetary savings.

The spending reductions from a more limited federal role in highways would save more than enough to cover the projected $15 billion shortfall in the Highway Trust Fund over the next five years. If the Congress does not reduce federal aid, this shortfall could be closed by increasing the current tax on motor fuel by two cents per gallon. (The possibility of raising motor fuel taxes is discussed in detail in REV-06.) About $4 billion in revenues could be generated from 1986 through 1990 by eliminating the motor fuel tax exemption for gasohol (equivalent to a subsidy of 60 cents per gallon), for state and local governments, and for local transit buses.

NDD-15 RAISE AVIATION USER FEES TO COVER AIR TRAFFIC CONTROL COSTS

	Annual Added Revenues (millions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	360	440	520	610	700	2,630

Aviation user fees--most important, an 8 percent tax on domestic passenger tickets and fuel taxes for private aircraft--currently recover the capital costs of building and equipping air traffic control facilities and fund federal grants for airport improvement. At present, however, these fees are not adequate to cover the federal government's costs of operating the air traffic control system. Charging aviation users for their total share of these costs would raise an additional $360 million in 1986 and $2.6 billion over the 1986-1990 period.

General aviation users--firms and individuals that own and operate aircraft for business or recreational use--pay only about one-tenth of their share of all federal aviation expenditures, while commercial aviation users overpay by about 20 percent. If general aviation users' fees were raised in 1986 to cover 40 percent of the costs these users impose and increased to 60 percent by 1990, the subsidy from the general taxpayer could be eliminated. Any increase beyond this level could be used to reduce the overpayment now provided by commercial aviation users.

General aviation user fees could be raised in several ways, including increasing aviation fuel taxes, imposing a sales tax on the purchase of new planes and equipment, or placing direct federal fees on general aviation. A sales tax on the purchase of new aircraft and equipment would probably be more equitable than a large tax on fuel, which would place a severe and disproportionate burden on recreational flyers, who make little use of the federal air traffic control system. A sales tax, by contrast, would target the much costlier corporate jets that are the heaviest private users of the system.

Charging direct federal fees would have the advantage of making a more explicit link between the fee charged each aircraft and the costs it imposes on the system. This approach would require resolving several issues, including jurisdictional questions, the administrative costs of collecting such fees compared with other aviation user fees, and the ability to identify air traffic control costs and allocate them accurately to individual users. The FAA's ongoing program to replace and modernize air traffic control equipment should, over the next decade, ease these problems by making it technically feasible to identify all users of the system and to allocate costs more precisely.

While higher fees for general aviation would encourage more efficient use of the nation's airport and airway system, opponents argue that general aviation users should not be forced to pay their full share of costs for an air traffic control system that was designed to meet the needs of large commercial jets. Further, they argue that the large cash balance in the Airport and Airway Trust Fund makes it unnecessary to raise user fees at this time. Increased fees for general aviation would also reduce sales by the manufacturers of general aviation aircraft.

NDD-16 REDUCE NASA'S COMMERCIAL AERONAUTICAL RESEARCH AND DEVELOPMENT

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	360	380	400	420	450	2,010
Outlays	160	330	390	410	430	1,720

The National Aeronautics and Space Administration (NASA) devotes about $400 million a year to commercially oriented aeronautical research and development (R&D) programs. This is in addition to the federal government's substantial support for defense-related aeronautical R&D. Some NASA funds support long-term R&D in areas that possibly are underfunded by private firms (aircraft noise and safety, for example). Other programs support the development of more fuel-efficient and better-performing aircraft--goals for which private incentives probably are adequate. Eliminating this second group of programs could generate outlay savings of $160 million in 1986 and $1.7 billion over the 1986-1990 period.

Advocates of retaining NASA's support for these programs note that reductions could have a negative effect on the international competitiveness of the U.S. civilian aircraft industry. Critics of this area of federal aid hold that there are no grounds for favoring this industry over others also facing international competition but receiving little R&D support.

NDD-17 ESTABLISH USER FEES FOR CERTAIN COAST GUARD SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	870	940	950	980	1,010	4,750
Outlays	870	940	950	980	1,010	4,750

User fees could be established for U.S. Coast Guard services that provide direct benefits to commercial mariners and recreational boaters. These programs, totaling about $1 billion in annual federal spending, include aids to navigation, search-and-rescue activities, marine safety, and marine environmental protection. Over the 1986-1990 period, full recovery of associated federal costs from mariners and boaters would yield $4.8 billion to offset Coast Guard outlays. In 1986, $870 million would be saved.

The Coast Guard provides substantial, uncompensated benefits to civilian navigation, especially to the commercial shipping industry. Without navigational aids, such as buoys and other channel markings, commercial shipping in U.S. inland and coastal waters would be considerably more difficult, hazardous, and costly than it is now. The capital and operating costs of these aids could be recovered from the shipping industry, just as highway users pay for the costs of roads. The Coast Guard also conducts search-and-rescue operations for lost or disabled vessels; about three-quarters of such activities assist recreational boaters. The costs of these services could be recovered through registration fees for recreational boats and other types of fees for commercial vessels. These Coast Guard services can be compared with emergency medical care and user fees with medical insurance premiums.

User fees might, however, be difficult to collect from recreational boats and would increase costs for the currently depressed fishing industry. (If Coast Guard fees for fishing vessels were phased in over five years to avoid imposing too sudden a financial burden on this industry, the federal budget savings would be reduced by about $500 million for 1986 through 1990.) Opponents of user financing for the Coast Guard's life-saving services see these as essential responsibilities that the federal government should finance.

NDD-18 ELIMINATE AUTOMATIC COMMUNITY DEVELOPMENT BLOCK GRANTS FOR LESS NEEDY JURISDICTIONS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	360	370	380	400	420	1,930
Outlays	10	140	330	380	390	1,250

Funding for the Community Development Block Grant (CDBG) program could be reduced by providing automatic funding only to the neediest jurisdictions, and distributing part of the savings among the less needy communities through a competitive system. All metropolitan cities and urban counties now are entitled to receive annual grants to carry out a wide range of community development activities of their choice, including housing rehabilitation, infrastructure improvement, and economic development.

In 1984, $2.4 billion--70 percent of total CDBG program funds--was appropriated for allocation on a formula basis among 691 metropolitan cities and 104 urban counties. If the entitlement component was cut 30 percent by eliminating automatic funding for the least needy communities, and half of the savings was devoted to competitive distribution among communities losing their entitlement status, federal expenditures could be reduced by $10 million in 1986 and $1.2 billion over the 1986-1990 period.

The entitlement component of the CDBG program now provides aid regardless of need, although needier jurisdictions receive larger grants. It can be argued that no pressing interest is served by supporting jurisdictions that have above average capacity to fund projects themselves. Although some worthwhile projects serving poverty pockets in affluent communities might not be feasible without federal aid, a reduction in entitlement funding coupled with a competitive set-aside would ensure that the most effective projects in better-off communities would still be funded while retaining the same level of aid for the most distressed jurisdictions.

On the other hand, CDBG funds in general must be used to aid low- and moderate-income households, to eliminate slums and blight, or to meet emergency needs. A reduction in federal funds for affluent communities would probably curtail such activities in those areas. In addition, a competitive set-aside would generate administrative costs associated with processing and evaluating proposals, and it presupposes a competent central evaluation system.

NDD-19 END FUNDING OF THE ECONOMIC DEVELOPMENT ADMINISTRATION AND URBAN DEVELOPMENT ACTION GRANTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Eliminate EDA						
Budget Authority	240	250	260	270	280	1,300
Outlays	140	190	220	250	260	1,060
Eliminate UDAG						
Budget Authority	440	460	470	490	500	2,360
Outlays	20	110	230	340	470	1,170

Federal spending for local economic development could be reduced by $160 million in 1986 and $2.2 billion over the 1986-1990 period by disbanding the Economic Development Administration (EDA) and eliminating the Urban Development Action Grant (UDAG) program. The EDA provides grants to state and local governments for public works, technical assistance, and job programs, as well as loan guarantees and direct loans to firms for business development. In 1985 appropriations for EDA programs will total $228 million. For the UDAG program, administered by the Department of Housing and Urban Development, $440 million was appropriated for 1985 for distribution to local governments through a competitive selection process. These governments use the funds, along with other resources, to finance economic revitalization projects.

Some critics of these programs contend that federal assistance should not be provided for activities whose benefits are local in nature and which, therefore, should be the responsibility of local governments. In addition, both programs have been criticized for the types of projects that they fund, for not directing funds to the most distressed areas, and for substituting public for private credit. In particular, EDA has been criticized for its eligibility criteria, which qualify areas containing 80 percent of the U.S. population, and for providing aid with little proven effect at great expense compared to other programs with similar goals. While the UDAG program has more stringent eligibility standards and some evidence exists that completed projects are meeting investment and employment expectations, grants are often provided for projects in vital commercial centers where full conventional financing might have been available.

On the other hand, the reduction in aid associated with the elimination of EDA and UDAG would curtail economic development activities in some distressed communities that might not be able to tap other resources. This could result in deterioration of infrastructure, loss of prospective jobs, and decreases in local tax receipts. The elimination of these two sources of funds might have especially serious consequences for the most distressed communities, particularly in view of overall federal cutbacks in urban aid programs.

NDD-20 TERMINATE THE ELEMENTARY AND SECONDARY EDUCATION BLOCK GRANT (ECIA, Chapter 2)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	560	590	620	660	700	3,130
Outlays	40	430	580	620	650	2,320

Federal assistance for elementary and secondary education could be reduced while preserving federal aid directed toward special groups and special needs by terminating the largely untargeted block grants for improvement of elementary and secondary education--Chapter 2 of the Education Consolidation and Improvement Act (ECIA). This would reduce outlays by $40 million in 1986 and by $2.3 billion over the 1986-1990 period.

Some would argue that, in a time of budgetary stringency, untargeted aid for activities primarily supported by states and localities should have low priority for scarce federal funds. Because Chapter 2 funds are primarily untargeted, many of the districts that would lose the most under this option do not have special needs for federal assistance. (Other, more directed programs, such as the Chapter 1 program for the educationally disadvantaged, would be retained.) Moreover, the effect of this program's termination would generally be small, since Chapter 2 contributes on average less than one-half percent of total school district funds.

On the other hand, the Chapter 2 block grant originated in part to free state and local education agencies from the restrictions of "categorical" federal programs. Unlike most federal elementary and secondary education aid, Chapter 2 funds can be used with little restriction for whatever purposes are deemed most important by local and state officials. Terminating the program would require them to rely on state and local funds for activities currently supported by Chapter 2.

NDD-21 REDUCE FUNDING FOR IMPACT AID

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	140	140	150	160	170	760
Outlays	120	140	150	160	170	740

For many years, various administrations and the Congress have debated "Impact Aid" (School Assistance for Federally Affected Areas), which provides aid to school districts whose tax bases might have been adversely affected by the presence of nontaxable federal property. The adverse impact can have two sources: families that live on federal property and thus are exempt from residential property taxes, and families that work in federal establishments that pay no commercial property taxes. Impact aid is accordingly paid for two classes of students: those whose parents both live and work on federal property (so-called "A" children), and those whose parents live or work on federal property ("B" children).

Recent controversy has focused primarily on B children. The Omnibus Budget Reconciliation Act (OBRA) of 1981 provided for a gradual elimination of all B payments. Such payments were never stopped, however, and the provision of OBRA calling for their elimination was repealed in 1984. The 1985 appropriation for B children was $130 million. Elimination of B payments would reduce outlays by $120 million in 1986 and by $740 million over the 1986-1990 period.

Opponents of B payments argue that federal presence in a district provides economic benefits, including enhanced property tax values and hence higher school receipts. They also note that in some states, Impact Aid may merely substitute for state assistance that would otherwise be provided to recipient districts. Finally, substantial B payments are received by some districts that appear in relatively good fiscal condition--in spite of, or perhaps because of, the federal presence. Such districts include ones in which many residents commute to federal jobs located in adjacent areas.

Proponents of B payments maintain that federal establishments remove property from the tax rolls, while imposing a service burden on local education agencies. They note that the economic benefits stemming from federal activities are similar to those generated by private--and thus taxable--firms. In addition, they contend that much of the fiscal benefit from federal presence is captured by sales and income taxes, which are not generally used primarily to support local education. Finally, they point to districts in which the fiscal burden imposed by B children is sizable--such as some rural districts in which much of the potentially taxable property is taken up by national forests, military bases, or other federal property.

NDD-22 INCREASE PELL GRANT TARGETING

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	360	380	400	420	450	2,010
Outlays	70	350	380	400	430	1,630

The Pell Grant program provides grants to undergraduate students who attend school at least half time. This program, which is directed more to low-income students than other federal student aid programs, is expected to provide grants to almost 2.9 million students in the 1985-1986 school year. About 45 percent of all Pell Grant aid goes to dependent students--virtually all to students from families with incomes below $30,000, of which more than two-thirds come from families with incomes below $15,000. Students who are financially independent of their parents receive the other 55 percent of the aid.

Grants will range between $200 and $2,100 for the 1985-1986 school year, averaging an estimated $1,250 per student. The amount of the grant is based on family income and other factors; only students who qualify for $200 or more receive any support. Raising the minimum award and the proportion of discretionary income that families are expected to contribute to educational costs would reduce federal outlays by $70 million in 1986 and $1.6 billion from 1986 through 1990. This option would reduce federal costs and at the same time protect the awards of the most needy recipients, because only the least needy of the current recipients would receive reduced grants. By lowering the grants of less needy students, who get rather small Pell Grants, this option is unlikely to affect students' enrollment decisions. On the other hand, the students who would be disqualified from grants under this proposal are from lower income backgrounds than many students who now receive other federal student aid and would continue to do so, if the other programs were unchanged.

NDD-23 REQUIRE COST SHARING FOR VA HOSPITAL CARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	120	280	310	350	390	1,450
Outlays	120	280	310	350	390	1,450

The Veterans Administration (VA) currently provides free hospital care first to veterans with service-connected injuries or illnesses, and then to other special groups of veterans without such disabilities, as beds are available. Among the latter--now 65 percent to 70 percent of all patients--are veterans who claim they cannot defray the costs of care elsewhere and veterans age 65 or older, who are eligible for care without regard to income, health insurance coverage, or financial need. All nonpoor veterans without service-connected disabilities could be required to make copayments equal to those under Medicare for the first 90 days of inpatient care. In 1986, veterans would pay about $452 for the first 60 days of a hospital stay and $113 for each day thereafter. The resulting receipts could reduce five-year VA outlays by $1.4 billion (net of administrative costs) and 1986 outlays by $120 million.

Proponents of such a change believe the VA's primary responsibility is to provide medical care to veterans with service-connected disabilities. They suggest that, over the next five years, increased demand from growing numbers of veterans reaching age 65 could jeopardize the VA's ability to meet adequately the needs of service-disabled and poor veterans. Establishing deductible amounts and coinsurance requirements for nonpoor veterans without service-related conditions would reduce their use of VA services by making VA care less attractive compared with private alternatives. It would also shift some of the rising costs of medical care to nonpoor recipients, many of whom are accustomed to cost-sharing arrangements at non-VA facilities.

Others suggest that copayment requirements would unfairly burden elderly veterans or limit their access to necessary care. Although VA patients would pay only a small portion of the costs of their care under this option, some opponents object to requiring copayments from combat veterans simply because they are not defined as poor. Some oppose the option because it would increase the uneven distribution of medical benefits available to veterans.

NDD-24 LIMIT ELIGIBILITY FOR VA HOSPITAL CARE TO SERVICE-DISABLED AND POOR VETERANS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	490	1,200	1,450	2,000	2,300	7,440
Outlays	490	1,200	1,450	2,000	2,300	7,440

Under current law and practices, the Veterans Administration (VA) provides inpatient hospital care to eligible veterans on a space-available basis, with first priority given to veterans with service-connected injuries or illnesses. If VA-supported hospital care were limited to veterans with service-connected disabilities and those unable to defray the costs of medical care, outlay savings from 1986 through 1990 would amount to $7.4 billion and those in 1986 to $490 million.

About one-fourth of the expected VA patients would be affected by this approach, assuming that the strongest impact would be on VA patients over 65, most of whom have no service-connected medical problems. In addition, some veterans under age 65, who are currently eligible for VA care, would not meet a strict needs test. Financial need could be based on income and include eligibility for means-tested benefits, such as veterans' pensions and food stamps.

Proponents favor this option principally because they believe that the VA's primary responsibility is to provide care to the service-disabled, and that VA resources should not be expanded solely to meet the future needs of the nonservice-disabled. They note that most veterans have access to private hospital care and have adequate insurance for hospitalization. Opponents argue that care for nonservice-related ailments was earned as an entitlement during service in the armed forces and any reduction in this care would violate an implicit contract.

One drawback to this approach is its possible side effects on the VA medical system. If the VA served significantly fewer veterans, it might have to scale back its medical school affiliations and, as a result, might no longer be able to provide quality care to some service-disabled veterans. Further, if the VA hospital system was reduced, it might not retain enough reserve capacity for military needs in time of war or national emergency.

The savings estimates assume no increase in utilization rates among service-disabled veterans, and no increase in poverty among veterans over age 65. But if, for example, the service-disabled clientele--who have automatic eligibility for free VA medical care--increased dramatically over the next five years, savings under this option would be reduced.

NDD-25 CONVERT UNDERUSED ACUTE-CARE BEDS IN VA HOSPITALS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	100	180	240	280	290	1,100
Outlays	90	150	210	270	260	980

The Veterans Administration (VA) now operates 172 hospital centers and 106 nursing homes, and is expanding its number of nursing homes at the rate of about three per year. About 20 percent of VA hospitals have very low occupancy rates, however, and more than one-tenth of the total acute-care beds are used for patients needing long-term care. Furthermore, VA hospital centers are experiencing rising demand for long-term care, largely because the veteran population over age 65 is growing rapidly.

If the VA converted its underused acute-care beds to nursing home care, it could scale back plans for the costly construction of new nursing homes. In some areas, it would even be possible to convert entire underused VA hospitals to nursing homes, which would reduce staffing and equipment costs. Converting roughly 5,500 of the VA's 79,000 hospital beds would save $90 million in outlays in 1986 and about $1.0 billion over the 1986-1990 period.

Advocates of such conversions point to the prospect of better suiting VA medical services to the patients being treated. They suggest that, because elderly veterans are a growing proportion of VA patients, an imbalance exists in the ratio of hospital to nursing home beds.

Opponents of such a shift view the potential reduction in hospital capacity in some areas as a serious hardship for veterans, who might prefer VA over private-sector hospital care. Cutbacks in coverage under the Medicare and Medicaid programs, they note, could motivate such a preference.

Some legislative action would be required to allow the VA to pursue the conversion of hospital beds. Current law now requires the VA to staff and operate at least 90,000 hospital and nursing home beds, and bed conversions could temporarily place the total number below that minimum.

NDD-26 END FUNDING FOR LEGAL SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	320	340	360	380	400	1,800
Outlays	290	330	350	380	400	1,750

The Legal Services Corporation (LSC), an independent, nonprofit corporation established in 1974 legislation, provides free legal assistance to the poor in civil matters. Despite repeated Administration efforts to abolish the program, the Congress continues federal funding. Termination of LSC would generate five-year outlay savings of some $1.8 billion and 1986 savings of $290 million.

The LSC has been the subject of considerable controversy from its inception. Critics have charged that the activities of legal aid lawyers too often focus on the advancement of social causes rather than on the needs of poor people with ordinary legal problems. The Administration and others believe that the responsibility for legal assistance should rest primarily with state and local governments. From this perspective, support from other federal grants, private sources, and donated services could help to meet state and local priorities for legal aid. Such an approach, it is argued, would increase local control, reduce overhead costs, and improve coordination among different social services.

Those opposed to terminating LSC argue that a specifically targeted federal assistance program is the only way to ensure that legal aid is available to those who cannot pay. They point out that inadequate local and private resources was one of the factors that led to direct federal financing, and believe that a strong federal program provides essential oversight and national direction. In response to the criticism that legal aid lawyers act as social activists, advocates of the program point out that restrictions passed by the Congress over the years provide guidance to curtail the activities some find objectionable.

FEDERAL PERSONNEL, MANAGEMENT, AND CONSTRUCTION

This category presents 13 options designed to reduce federal costs for agency management, civilian employee compensation, and construction. The first six options suggest ways to enhance the management of federal agencies by improving job classification, by consolidating or closing offices and facilities, by reorganizing activities to reduce duplicative work and increase sharing of services, and by modifying the structure of the civilian work force. The next five options, CIV-07 through CIV-11, would reduce the cost of employee pay and benefits: CIV-07 suggests approaches to reducing pay costs; CIV-08 through CIV-10 would reduce the costs of civilian retirement, disability, and health benefits by bringing some federal practices more into line with those of the private sector; and CIV-11 would limit employee travel.

The remaining two options would reduce federal construction costs. CIV-12 would temporarily suspend some construction and improve the management of changes to construction contracts. The final option would change overtime provisions covering government contract work that involves construction or the production of goods.

The savings estimates set out in this category assume that each reduction measure would be implemented alone. If they were implemented together, savings would be less than the sum of the amounts indicated for each item.

CIV-01 CORRECT MISCLASSIFICATION OF GENERAL SCHEDULE JOBS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	45	200	300	350	370	1,265
Outlays	40	180	280	330	350	1,180

The federal government assigns most of its white-collar jobs to one of the 18 pay grades of the General Schedule (GS). It does so by means of a classification system that compares duties and responsibilities of positions to job standards prepared by the Office of Personnel Management (OPM). Based on OPM audits, about 200,000 full-time permanent positions have incorrect grades. Of these jobs, nearly 90 percent have grades higher than their duties and responsibilities warrant. Under current law, downgraded workers may keep the higher grade and pay for up to two years, thus limiting the potential savings available when misgrading is corrected. If the Congress mandated identification and correction of misgrading and severely modified these statutes--by, among other things, eliminating the two-year grace period--five-year outlay savings could reach $1.2 billion.

Correct classification helps ensure that employees earn pay consistent with their duties and responsibilities. Proponents of modifying the statutes that protect grade and pay argue that the government should not wait to achieve the efficiencies associated with correct grading, and that postponing salary adjustments for downgraded workers eliminates budgetary incentives to regrade positions. Opponents maintain that current law cushions the effects of regrading on employees, who have usually been misgraded through no fault of their own, and that management needs the cushioning effect to make regrading acceptable and to maintain morale.

CIV-02 IMPROVE MANAGEMENT OF CIVILIAN AGENCY ACTIVITIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	--	180	240	250	260	930
Outlays	--	160	220	230	240	850

The President's Private Sector Survey on Cost Control (PPSSCC) recommends scores of organizational and staffing changes designed to improve civilian agency operations without lowering service levels. Although some of the changes have already been made and others are in progress, significant opportunity remains for further improvement. Most of the remaining initiatives could be carried out administratively. Congressional oversight and appropriation action, however, could enhance the prospects of timely implementation.

The major reorganizations recommended by PPSSCC and described below would require restructuring regional and field offices, consolidating or closing certain underused facilities, and reducing duplication and staff layering. While separately the individual measures have relatively little impact, if adopted together they could reduce employment by some 6,100 jobs, generating five-year outlay savings of $0.8 billion. In the longer term, further savings would derive from the lower federal retirement costs, as a result of the decrease in personnel.

The PPSSCC proposals to consolidate agencies' regional and field offices--potentially eliminating about 1,700 jobs--seek more effective management, elimination of duplicative functions, and more efficient administrative support services. Anticipating economies of scale, many of the proposed consolidations call for somewhat larger but fewer local offices. The Agricultural Research Service, the Federal Aviation Administration (FAA), and the U.S. Customs Service would reduce the number of regions and centralize administrative support services. The U.S. Forest Service would close state offices and combine their functions in regional headquarters. Other consolidations at Customs, based on work load and geographic considerations, would close 13 district offices, 45 ports of entry, and a few related substations. Increased use of automated data processing would also improve service delivery by consolidating centers that appraise goods entering the United States.

Closing underused special-purpose facilities could also reduce costs. The FAA, for example, could close most of the smaller stations providing weather and other flight services to pilots, nearly one-third of air route traffic control centers, and some 50 low-volume control towers, while reducing operations at other towers, according to the PPSSCC. With the introduction of new technology, the FAA could carry out these measures and achieve the associated savings without jeopardizing air travel safety. These measures would eliminate about 1,400 positions.

According to PPSSCC, reducing staff layering and duplication within the federal government would increase management accountability and responsiveness and streamline operations. Such reorganizations could eliminate about 3,000 positions. The Department of Health and Human Services, for example, could reorganize several major agencies--the Office of the Secretary, the Office of Human Development Services, and the Office of the Assistant Secretary for Health. This would account for most of the staffing reductions. In addition, the Department of Agriculture's Forest Service would reorganize along a programmatic rather than functional line to reduce requirements for administrative, engineering, and planning staff.

Contrary to claims by PPSSCC, opponents believe the proposed staffing changes will adversely affect delivery of public services. At a minimum, they argue, major reorganization would temporarily disrupt agency operations, threaten productivity and service quality, and reduce employee morale. Moreover, experienced workers might not transfer to new locations. Other critics might challenge PPSSCC findings on usage and service levels and point to reduced accessibility to the public--especially with regard to closing customs and aviation facilities.

The reported budgetary savings use the estimates of personnel reductions prepared by PPSSCC but apply CBO's current and projected average compensation costs. The reorganizations are assumed to be completed at the start of 1988. Certain transition costs, such as those for relocating equipment and personnel, are assumed to be offset in the first two years by savings in compensation and in other expenditures such as rent, utilities, and supplies. (A related reorganization measure, CIV-03, addresses reductions in personnel staff.)

CIV-03 REORGANIZE GOVERNMENT PERSONNEL OFFICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	40	110	220	250	270	890
Outlays	40	100	200	230	250	820

The President's Private Sector Survey on Cost Control (PPSSCC) recommends governmentwide changes in personnel administration, together with further research, to bring federal personnel staffing ratios in line with those in private industry. The federal government employs more than 33,000 professionals and support staff in 1,700 offices to carry out its personnel management functions. The PPSSCC found a private-sector ratio of employees to personnel workers of 150:1, while the average governmentwide ratio is 60:1. Moreover, personnel organizations and staffing structures vary widely throughout the federal civil service. Some of these differences may be attributable to such factors as requirements resulting from labor relations procedures, program expansions or reorganizations, major reductions in force, and geographic dispersion of offices. Such factors, however, do not seem to explain the wide variations in the ratio of employees to personnel workers, which ranges from 141:1 in the Social Security Administration to 40:1 in the Department of Labor.

In particular, the PPSSCC proposes that small personnel offices with less cost-effective staff be encouraged to obtain personnel support from service centers run by other agencies such as the General Services Administration. Other measures, not specifically recommended by PPSSCC, such as streamlining procedures and increasing use of new technology, could also improve productivity. If such measures raised the number of employees served by each personnel worker from 60 to a minimum of 75, for example, about 7,000 personnel positions could be eliminated, with resulting five-year outlay savings of $0.8 billion. Even with this modest improvement, however, there still would be nearly twice as many personnel workers per federal employee as in the private sector, according to the PPSSCC.

Proponents argue that consolidating personnel services throughout the government could reduce unnecessary staffing and paperwork. Also, they maintain that administration would be improved by eliminating layering in personnel functions and by allowing more timely hiring of new staff and other personnel actions. Critics counter that personnel functions in different agencies are too dissimilar to permit consolidation, that personnel administration needs to be closely integrated with the management of the agency, and that staffing cuts could lower the quality of support services. They also point out that the autonomy of agencies and the existence of long-standing practices make consolidation difficult. Furthermore, they assert that although federal management objectives are not dissimilar from those in the private sector, civil service statutes and regulations make special demands in the areas of promoting equitable treatment of employees and providing due process for personnel actions. Personnel administration practices in the private sector, they argue, therefore cannot serve as a basis for reorganizing federal personnel offices. Proponents, however, express skepticism that the unique aspects of a governmental environment account for such a large difference in staffing ratios.

Personnel reorganization would, of course, require detailed analysis before being carried out. In addition, the timing of any major reorganization or cutback in personnel staff may need to recognize the possibility of added personnel work that could arise from other measures that would accelerate audits of position classification or cause major reductions in force.

CIV-04 MODIFY STRUCTURE OF FEDERAL WORK FORCE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Increase Contracting Out						
Budget Authority	60	100	210	430	640	1,440
Outlays	-25	--	30	220	390	615
Reduce Middle-Management Jobs						
Budget Authority	480	820	1,200	1,450	1,550	5,500
Outlays	430	760	1,150	1,350	1,450	5,140
Total						
Budget Authority	540	920	1,410	1,880	2,190	6,940
Outlays	405	760	1,180	1,570	1,840	5,755

Shifting support jobs now performed by federal employees to private-sector contractors and reducing the portion of General Schedule (GS) workers at middle-management grades (GS-11 through GS-15) would reduce federal costs. Combined outlay savings through 1990 could total $5.8 billion.

Increase Contracting Out. Private contractors can often provide the government with supply, maintenance, and other support services at lower cost than in-house federal workers. Administration policy requires agencies to rely on the private sector, but current statutes make exceptions for some agencies. One of the largest exemptions, the Veterans Administration (VA), employs about 20 percent of all civilian workers outside the Department of Defense (DoD). Should agencies vigorously pursue contracting out and should the Congress permit it governmentwide, including the VA, some 140,000 federal jobs could shift to private firms. Reduced personnel costs, offset in part by higher contract spending, would result in cumulative five-year savings of $615 million. Outlay savings in the near term are small, because retirement savings are deferred and transition costs arise. Annual savings in later years, when retirement savings are realized, could reach more than $1 billion. Additional savings could be achieved if statutory exemptions covering activities now deemed critical to the national defense were reduced.

Advocates of contracting out point to it as economically prudent. At DoD, for example, preliminary data reveal that the cost of contractor operations averaged almost 25 percent below the cost of in-house operations. Supporters buttress their position by arguing that the federal government ought not to engage in commercial activities that the private sector can provide. Opponents' concerns focus largely on the lower quality of services that they allege contractors often deliver, and on the concerns of federal employees threatened by loss of jobs. Critics also point to studies showing that most of the savings achieved by contractors is attributable to better management techniques that could, if adopted, reduce federal costs without contracting out. Restrictions on contracting out, they argue, are necessary to help protect the government's ability to fulfill its special obligations, including those to patients in VA hospitals. According to this line of thought, when work is kept in-house, managers retain more control over work and can better assure the quality of services at VA facilities.

Reduce Middle-Management Jobs. In addition to contracting out, the government could consider reducing the number of jobs at higher grades. CBO's analysis indicates that the government appears to have a disproportionate share of middle-management positions compared with the private sector. A recent Administration proposal would gradually shift 40,000 positions graded GS-11 through GS-15 to lower grades (without changing total employment). Where it deems appropriate, the Congress could reduce appropriations for operating expenses to reinforce Administration action. Savings under the Administration's plan could amount to $5.1 billion over the next five years.

Reducing middle-management jobs, say proponents, permits restructuring of the work force within the context of current compensation and personnel management practices. Critics caution that the plan could cause problems for managers, who would be left to carry out missions with lower-skilled personnel. The plan could also lower morale and hinder recruitment and retention. Critics note that the problem of high federal grades has resulted, in part, from managers' attempts to compensate for below-market salaries. They point out that while federal grade distributions appear out of line with the private sector, pay distributions do not. From this perspective, a more comprehensive reform of federal pay and personnel administration is in order.

CIV-05 CONSOLIDATE OR CLOSE MILITARY BASES OR ACTIVITIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	-90	-100	230	290	340	670
Outlays	-90	-120	210	270	320	590

The Department of Defense (DoD) currently relies on some 400,000 civilian federal or contract employees to provide supply, maintenance, and other support for its military operations. Reviews by DoD, the Office of Management and Budget, the President's Private Sector Survey on Cost Control (PPSSCC), and the General Accounting Office (GAO) have identified various initiatives that would help improve the efficiency of military support.

Because such initiatives involve major funding decisions about personnel and facilities, and because of intense concern about the potential for disrupting national defense and local economies, the Congress could direct preparation of a comprehensive plan for improving the efficiency of the nation's military support. Such a plan could incorporate PPSSCC proposals and be reviewed by the Congress.

Drawing on previous proposals, the major components of the plan would likely include improving maintenance and supply activities and much greater sharing of support services to military bases in the same geographic areas. Other measures, with much smaller impacts, might include closing or consolidating bases because of changing military requirements or opportunities for more efficient location of operations. Finally, reorganizing the administration of defense contracts might also be considered. Analysis of available data suggests that such measures might reduce the number of civilian employees required to support defense activities by the equivalent of as many as 16,000 jobs over the next five years; but details for definitively estimating such reductions are not available. A reasonably aggressive target, capturing about two-thirds of this estimate, could produce net savings in civilian support activities of $590 million through 1990. Net cost increases arise in the first two years for transfer of personnel and other implementation expenses. Most new capital costs, however, are assumed to be covered by reprogramming within budgeted resources. In the long term, additional savings, not estimated here, could derive from greater use of competitive bidding, reduced transportation requirements, and lower retirement costs because of a smaller federal civilian work force.

Analyses by GAO support efforts to improve supply and maintenance activities. Based on these reviews, up to 5,800 DoD civilian jobs might be cut by reorganizing the supply of spare parts and other short-life items, closing some of the 30 wholesale-like supply depots, and consolidating depots performing aircraft or other maintenance that requires extensive capital investment.

Expanded sharing of base support services, other than consolidating supply and maintenance, could eliminate as many as 8,800 equivalent full-time jobs. Proponents urge the use of shared support facilities for installations, regardless of branch, within about a 50-mile radius. Based on past studies, GAO believes that DoD's plans for more sharing could be greatly accelerated. (CIV-04 seeks economies through more contracting out for support services; its adoption would preclude most of the savings from shared services.)

Advocates of altering or terminating missions at some bases point out that DoD has not advanced a major base realignment package since 1979. Smaller bases generally have much higher support costs and proportionately more support personnel. A few prospects for realignments identified by DoD in the 1979 package have not been put into effect. But their potential for reductions in the civilian work force is relatively small.

The PPSSCC proposes far-reaching consolidation and reorganization of contract administration at DoD. In 1979, DoD proposed reorganization of the Defense Contract Administration (DCA) into 5 rather than 9 regions with 37 rather than 47 area offices--potentially shrinking the agency's work force by about 4 percent. If the individual service branches achieved similar economies through departmentwide consolidation of contract operations, together with those proposed for DCA, some 1,100 jobs might be abolished.

Past consolidation proposals have been opposed on the ground that they would disregard the unique requirements and capabilities of the individual military services, diminish responsiveness to program managers, and decrease military control and flexibility necessary to maintain preparedness. Some critics note that recent force expansion and associated mobilization requirements restrict opportunities for further consolidations, while others point to the absence of the accounting data and mobilization criteria needed to make sound decisions on consolidation. Still other opponents express concern about the uncertain costs associated with transferring personnel and constructing new facilities. Finally, local communities have raised legitimate concerns about increased unemployment and loss of business tax revenue. DoD's Office of Economic Assistance has eased transition problems in the past, however, by channeling federal assistance and by making surplus federal property available for commercial and industrial development.

CIV-06 CONSOLIDATE FEDERAL GRANT-IN-AID PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	20	10	230	240	270	770
Outlays	10	0	210	220	250	690

The federal government aids state and local jurisdictions through scores of programs that provide assistance in a variety of forms including categorical grants, block grants, and general revenue sharing. Most grant programs, particularly the categorical ones, were established to guide the allocation of public funds toward issues of high national priority, such as transportation and education, that often transcend local needs. Some programs require matching funds and supplement financial aid with technical assistance. During the past decade, the role of the federal government in administering these programs has been much debated, many block grant or revenue sharing proposals have been advanced, and several have been enacted. Some planners, however, favor much greater consolidation.

One approach would be to consolidate the current system, which covers nine block grant programs and a score of major categorical programs, into a half-dozen or so "megablock" grants. This would simplify administration and allow much wider state and local discretion in determining local priorities and how to meet them. Such a comprehensive and controversial change in intergovernmental relationships could also reduce the targeted federal work force from the equivalent of 10,900 current full-time positions to 4,400. Associated five-year budgetary savings could reach $0.7 billion. The work-force reductions could be achieved without shrinking the total amount of grant funds available for recipients. Programs involving direct payments to individuals, such as Medicare and Food Stamps, would not be included in the consolidation. (Other grant-in-aid reductions, addressed in NDD-20 and NDD-21 would curtail or eliminate some programs.)

The formulas for distributing funds would attempt to retain present allotment patterns, but some funding changes would probably occur. Budgetary savings would be achieved because reduced administrative requirements, management review, and technical assistance would require fewer personnel. The Office of Management and Budget found that the consolidations enacted in 1981, which created nine block grant programs out of many smaller programs and reduced some grants, achieved personnel reductions of over 80 percent. Savings estimates in this proposal assume a 60 percent work-force cutback.

Pointing to troublesome regulations that attend the current system, proponents of further grant consolidation maintain that localities should have greater flexibility to respond to their own needs and wider discretion in carrying out most federally funded programs. They add that consolidation would eliminate duplication of programs and funding sources. Critics counter that the federal government should control the money it disburses to avoid waste and abuse and to achieve national program objectives. They warn that consolidation on a megablock scale could eventually divert public funds from the identified problem areas that initially gave rise to the need for federal assistance, and that too much local discretion might weaken such programs as transportation and pollution control, which require coordination among local jurisdictions. Other critics express concern that state governments might overlook the needs of central cities in favor of programs or tax relief for wealthier suburban communities. Federal oversight, opponents argue, ensures that funds remain targeted toward the very needy. Finally, they point out that state and local personnel costs could rise to assume work previously done by the federal government.

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CIV-07 REDUCE FEDERAL PAY ADJUSTMENTS FOR CIVILIAN EMPLOYEES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Freeze Annual Pay Adjustment in 1986						
Budget Authority	1,500	1,700	1,800	1,900	2,000	8,900
Outlays	1,500	1,800	1,900	2,000	2,100	9,300
Install Permanent Three-Month Delay of Annual Pay Adjustment						
Budget Authority	400	500	700	800	900	3,300
Outlays	400	500	700	800	900	3,300

Under current law, the nation's 1.6 million federal white-collar employees may receive an annual pay adjustment based on methods that compare federal and private-sector salaries for comparable jobs. The 500,000 federal blue-collar employees receive an annual adjustment that occurs locally and at different times throughout the year.

The Congress can reduce civilian personnel costs by imposing a one-year freeze on the annual pay adjustment for both white- and blue-collar employees or by legislating a permanent three-month delay in the effective date of the annual pay adjustment. (The delay for all white-collar employees would be from October until January; blue-collar employees would continue to receive an adjustment at different times throughout the year, but three months later than they do under current law.) One-time three-month delays have been imposed in fiscal years 1984 and 1985. Continuation of the delay would maintain a 12-month adjustment cycle.

A pay freeze in 1986 would reduce outlays over the 1986-1990 period by $9 billion. A permanent three-month pay delay would achieve outlay savings of $3 billion through 1990. Delaying the adjustment for six months rather than three would increase outlay savings to $7 billion over five years. In each case, about four-fifths of the savings would come from white-collar employees. The Congress could also freeze for one year within-grade increases and merit raises other than promotions, which together would save more than $4 billion in 1986-1990. Greater reductions in outlays could be achieved by imposing a 1 percent pay cut in 1986. Five-year savings would total $12 billion. For each additional 1 percent reduction, five-year savings would total $3 billion. These savings are measured against the CBO baseline, which assumes that the annual growth of federal employees' salaries will match that of salaries in the private sector.

In assessing changes to federal pay procedures, the Congress will want to weigh potential budgetary advantages against the government's need to attract and retain a qualified work force. Proponents of limiting pay increases argue that a one-year freeze or a delay in the effective date is required to help reduce projected budget deficits. This view is consistent with past actions that have restrained 8 of the last 10 annual adjustments because of overriding economic considerations. Continued limitations, they point out, would be in keeping with several recent union agreements and with measures taken by state and local governments that have frozen or reduced their employees' pay and benefits. Moreover, they argue that the effects of pay restraint on personnel recruitment and retention are mitigated by slack job markets in some sectors of the economy.

Critics respond that, in fact, job markets have tightened as unemployment rates declined. They add that although the Administration has abandoned past plans to freeze pay for one year, it has imposed a three-month delay in both 1984 and 1985, capping the 1985 raise at 3.5 percent. As a result, during the last four fiscal years, federal pay rates will have risen by about 17.3 percent--increasing by about 4 percent a year. By contrast, the four-year change in private-sector pay, as measured by the Employment Cost Index for the period ending October 1984, was 28.7 percent--about one and two-thirds times the growth in federal rates. If federal pay continues to lag behind that in the private sector, the morale of federal employees could drop, causing experienced employees with marketable skills to look for work outside the government, and making federal jobs less attractive to prospective recruits.

CIV-08 MODIFY CIVIL SERVICE RETIREMENT PROVISIONS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	--	60	130	180	220	590
Outlays	110	310	530	780	1,000	2,730

Nearly all federal civilian workers hired after December 1983 participate in Social Security's pension and disability programs and a yet-to-be-defined supplemental retirement plan. But 1.9 million annuitants and 2.6 million workers, including employees of the U.S. Postal Service, participate in a retirement program that predates and remains independent of Social Security--the Civil Service Retirement (CSR) system. Compared with benefits private-sector workers typically receive from employer-provided pension plans coupled with Social Security, CSR benefits are costly.

In the coming months, the Congress will confront the question of what level and type of retirement benefits federal employees should earn. The following modifications would not only bring CSR provisions for current participants, in an orderly manner, closer to those of the private sector, but also reduce costs:

- Provide annual cost-of-living adjustments (COLAs) each January but only half-COLAs for CSR income that exceeds $1,000 per month in 1985 dollars; 1990 outlay savings of $0.6 billion. (This change would affect new as well as current CSR retirees.)

- Reduce benefits earned after October 1985 by 2 percent for each year a person retires before age 62; savings of less than $50 million in 1990.

- Gradually change, over the next four years, the salary base used to calculate benefits from a three-year to a five-year average; 1990 savings of $0.2 billion.

- Phase out CSR survivor benefits for students between 18 and 22 years of age; 1990 savings of less than $50 million.

- Base annuity reductions for survivor benefits on actuarial factors, which vary by the age of the retiree; 1990 savings of $0.2 billion.

With the exception of the provision to limit COLAs, these modifications would yield relatively small outlay savings in the first five years. But as more and more employees retire, significant savings would accrue from the non-COLA benefit reductions. The two most generous elements of the CSR system are the COLA provisions and the availability of a full or unreduced annuity at relatively early ages (age 55 with 30 years of service, or age 60 with 20 years of service). Private employers typically award COLAs on an ad hoc basis and reduce the initial benefit level for individuals retiring before age 62.

A number of private employers supplement pensions with stock options, thrift plans, and other types of capital accumulation accounts with preferential income tax advantages that are unavailable to federal workers. If such supplements were not considered in efforts to achieve comparability, more stringent CSR modifications could apply.

Those who oppose any cut argue that CSR is part of a "contract," albeit one without legal standing, that has linked a generous retirement system to salaries held below market rates. They also believe it is premature to adjust CSR benefits until the dimensions of the pension plan for new federal workers are known. Finally, some believe that the government should offer an exemplary retirement program for other employers to emulate--particularly with regard to COLAs. (Across-the-board COLA reductions, addressed in ENT-13, would apply to the CSR program.)

Proponents note that the government's 1986-1990 costs for indexing CSR benefits, if unchecked, will exceed $13 billion. Smaller COLAs patterned after private-sector retirement practices could help diminish differences between the value of retirement benefits earned by current CSR participants as a group and by newly hired workers. If differences were to persist, work-force morale and productivity could suffer, especially as the percentage of federal workers with CSR coverage declines. The distribution of the modified CSR benefits, however, would continue to favor long-term employees at the expense of federal workers who leave before retiring. These workers are unable to carry any CSR disability or survivor protection to their next job; most forgo the right to a deferred pension, beginning at age 62, by withdrawing their CSR contributions--without receiving matching contributions from their employing agency and with little if any interest earnings.

CIV-09 RESTRICT LONG-TERM DISABILITY BENEFITS AND ELIMINATE SICK-LEAVE CREDIT FOR FEDERAL EMPLOYEES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	--	--	--	--	--	--
Outlays	35	110	190	270	370	975

The Civil Service Retirement (CSR) system provides long-term disability benefits to an employee who cannot perform the critical functions of his or her job or one at the same pay grade. In addition, retirement benefits, which reflect years of service, count accumulated unused sick leave as if it were time spent working. Adopting Social Security's disability criterion and not crediting CSR for unused sick leave would reduce federal retirement outlays by $1 billion from 1986 through 1990.

Restricting eligibility requirements for long-term disability would reduce the number of employees who could begin receiving benefits. Although difficult to determine, the estimate assumes that the number of employees starting disability benefits under current practice would be reduced by about one-half--slightly under 20 percent would shift to regular retirement, but benefits based on age and length of service might be somewhat lower; about 30 percent would not qualify for either disability or regular retirement because they could not satisfy age and length-of-service criteria.

Critics claim that a tighter CSR disability criterion might cause managers to let employees stay on the job even if they could not perform adequately. Also, they argue, bringing federal disability protection more in line with private-sector practices should apply to benefit levels and eligibility standards. If federal disability benefits were increased to reflect typical private-sector levels, however, the total federal disability costs would rise.

Proponents note that eliminating retirement credit for unused sick leave would reduce the initial level of new federal pensions by about 2 percent. This suggests annual long-term savings in today's dollars would exceed $350 million. Workers who have accumulated substantial sick leave credits, however, might well argue that it is unfair to change a condition of their employment in a way that forces them to choose between forfeiting earned leave and making dubious claims to sickness prior to retirement.

CIV-10 MODIFY FEDERAL EMPLOYEES HEALTH BENEFITS PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	40	100	180	280	390	990
Outlays	40	100	180	280	390	990

The Federal Employees Health Benefits (FEHB) program offers health insurance coverage for federal employees and annuitants (that is, retirees) and their dependents. In 1984 the program covered about 10 million enrollees at an annual premium cost to the federal government of approximately $3 billion. About half of this amount was paid to hospitals for services provided to FEHB enrollees.

Program costs could be reduced by reforming hospital reimbursement procedures. Currently, FEHB insurance carriers pay hospitals on a "reasonable" cost basis. An alternative reimbursement system could require carriers to set up a prospective payment system similar to that now used by Medicare. Diagnosis related groups (DRGs), adjusted for all ages, could be created so that hospitals would receive a flat payment per case based on a patient's diagnosis. Any hospital that accepts federal reimbursement from Medicare could be required to accept this predetermined rate as payment for FEHB enrollees. A hospital would be prohibited from charging enrollees more than the DRG amount the carriers are required to pay--with the exception of deductible and coinsurance amounts, services not covered by the carrier, and services furnished to enrollees who choose to stay in the hospital after such services have been deemed medically unnecessary.

Savings realized by FEHB insurance carriers under this prospective payment system would allow for lower premium payments by both enrollees and the federal government. The five-year savings of $1 billion shown above represents only the federal budgetary savings. This estimate assumes that annual increases in DRG reimbursements would be tied to the hospital price index plus an additional one-quarter of one percent to permit technological advances. Historically, FEHB hospital payments have risen faster than hospital prices as a result of increases in numbers of services provided and of procedures performed per patient. This trend could be expected to continue in the absence of a prospective payment system.

Supporters of a prospective payment system argue that limiting the amount that carriers reimburse hospitals would provide needed incentives for hospitals to contain costs. In their view the current FEHB system enables hospitals to provide more amenities, more technology, and more staff than are necessary, which drives up the cost of hospital care. Their objective would be to increase hospital efficiency while maintaining the quality of health care. In addition, some support this proposal because it would avert potential shifting of costs from Medicare to other third-party payers, including FEHB carriers, that reimburse without DRG limits.

Opponents of this proposal argue that the quality of health care for FEHB enrollees could be adversely affected. The DRG payment is designed to cover the average hospital cost for patients who fall into a specific DRG. Because the payment is unrelated to the amount of care required by each patient, hospitals would profit from cases where a patient was healthier than average, and would suffer a financial loss when a patient was sicker than average. Under such economic incentives, opponents argue, hospitals might avoid treating patients with severe illnesses and might encourage profitable admissions of those with minor health problems who do not necessarily require hospitalization. Some critics are also concerned that over time DRG relative prices might diverge from costs, causing hospitals to discourage admissions of enrollees who would fall into a low-profit DRG and to specialize in those DRGs that have a high profit margin.

CIV-11 REDUCE FEDERAL TRAVEL EXPENSES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Budget Authority	270	290	300	325	350	1,535
Outlays	250	265	280	300	320	1,415

The Executive Branch spends about $5 billion a year on employee travel and transportation. Appropriation action requiring a 5 percent across-the-board cut in travel expenses would save $1.4 billion over five years. About 70 percent of this savings would arise from reductions in military travel.

The General Services Administration (GSA) and Department of Defense (DoD), which manage travel arrangements for civilian and military personnel, respectively, report that recent improvements in procurement methods have reduced government travel expenses. Despite these achievements and an across-the-board limit on the 1982 travel budget required by the Omnibus Reconciliation Act of 1981, the amount of travel dollars spent per employee increased by 42 percent between 1980 and 1984, while prices for travel services during the same period increased by only 35 percent. Although the improvements implemented by GSA and DoD have eliminated some travel expenses, the General Accounting Office states that additional changes in travel management could produce further savings.

Proponents argue that an across-the-board reduction in 1986 would prompt agencies to pursue more aggressively those measures already identified, which take advantage of lower prices, improve travel accounting, and eliminate low-priority travel. With improved management, they say, agencies could achieve reductions without significantly cutting back travel.

On the other hand, enactment of a 5 percent travel limitation runs the risk of creating difficulties for programs that rely heavily on travel for effective management. Agencies with many field offices or contractors, for example, may face inefficiencies or added costs in other areas if required to make cuts in travel. Opponents of a limitation on travel point out that the risk of inefficiencies increases as possible management improvements and cuts in low-priority travel are exhausted. Finally, some would argue that limitations on military travel would interfere with national defense activities. If military travel was exempted from the 5 percent reduction, however, the budgetary savings would greatly diminish.

CIV-12 ALTER FEDERAL CONSTRUCTION PRACTICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Savings
			Defer Construction			
Budget Authority	510	530	550	-560	-590	440
Outlays	120	290	480	370	90	1,350
			Control Change Orders			
Budget Authority	160	160	170	170	180	840
Outlays	40	95	130	150	170	585

Outlays for direct federal construction and rehabilitation of military housing, water projects, and other physical assets total about $11 billion annually. Near-term federal outlays could be substantially reduced by temporary suspension of some planned construction, as well as by improved management and control of procedures for changing construction contracts.

Defer Construction. One possibility is a temporary moratorium on some federal construction. A three-year deferral of half of newly funded nondefense construction could generate five-year savings of about $1.4 billion. Within these limitations, the Congress could require the Executive Branch to select the projects to be deferred.

In the past, temporary deferrals of certain federal construction activities have been used as one way to deal with fiscal challenges. Proponents point out that imposing a temporary moratorium would generate savings, while allowing priority work to continue and ensuring that any disruptions would be short-lived. The freeze could lead to the elimination of some low-priority proposals and would allow the Executive Branch time to expand its use of better approaches to construction management, including those covering design specifications and cost-effectiveness reviews. Critics argue that a moratorium on construction would only delay rather than permanently lower federal expenses, while disrupting planning and other aspects of construction programs. As a result of such actions, they point out, agencies often face higher prices and project backlogs that stretch resources and make orderly capital development difficult. During the moratorium, moreover, some agencies might find it difficult to meet program obligations given the delayed completion of necessary structures and facilities.

Control Change Orders. Achieving better control of change orders could also reduce federal costs. Change orders are used to make additions, deletions, or other modifications to construction work under way. Because they are negotiated, change orders tend to raise the cost of work above what it would have been as part of the original, competitively bid contract. Total federal construction costs could reasonably fall by $585 million over five years through the use of improved management procedures designed to reduce both the prices negotiated for change orders and their number. (Outlay savings would diminish if change order controls were coupled with a construction moratorium.) As one improvement, agencies could be required to obtain independent cost estimates for use in negotiating prices of change orders. Although such changes could be accomplished without legislative action, close Congressional oversight would help assure implementation.

Change orders provide the government and contractors with the flexibility to meet unforeseen circumstances and requirements. Regardless of the controls established, the government cannot avoid all changes. Because of their cost, however, such changes should be kept to a minimum and be reasonably priced. Government audits of agency management of change orders have found a number of deficiencies, including inexact or incomplete project designs and failure to use independent cost estimates. Mandated management improvements to correct such deficiencies would be consistent with those federal efforts to control waste and to improve the efficiency of government operations.

CIV-13 CHANGE OVERTIME PROVISIONS FOR FEDERAL CONTRACTS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1986	1987	1988	1989	1990	
Budget Authority	510	530	560	580	600	2,780
Outlays	60	250	450	510	550	1,820

NOTE: These estimates assume that the average savings would equal 0.5 percent of covered outlays; definitive data are not available.

The Walsh-Healey Public Contracts Act sets certain labor standards for work done under contract to the federal government that involves the production, specifically for the government, of goods worth more than $10,000. One provision requires that covered employees who work more than either 8 hours a day or 40 hours a week be paid at least one and one-half times their basic rate of pay. A similar provision in the Contract Work Hours and Safety Standards Act covers workers on federally funded or federally assisted construction projects.

These provisions could be changed to require overtime premium pay only for work beyond 40 hours a week on all new contracts covered by these acts. This option would bring the requirement for federal contractors in line with the Fair Labor Standards Act, which governs private-sector activity. Savings would result both from reducing total overtime pay and from encouraging more firms to bid for federal contracts. Some firms are now deterred from bidding because they would have to alter their established work practices. The magnitude of the savings would depend on the volume of new contracts and on the extent to which lower costs would result. Over the 1986-1990 period, CBO estimates that there will be new budget authority covered by these laws of about $550 billion and covered outlays of $360 billion. Cost savings assume efficiency gains of at least 0.5 percent.

Proponents of changing the overtime provisions argue that, in addition to conforming to private-sector practice, doing so would facilitate the adoption of nontraditional work schedules. In particular, compressed work schedules--such as the 4-day, 40-hour week--could be used by federal contractors without incurring overtime rates. Such schedules are already permitted for most employers, including the federal government itself.

Opponents argue that eliminating the overtime premium requirement would put some firms--for example, those in which daily overtime premium pay is provided in union agreements--at a competitive disadvantage. Moreover, alternative work schedules are not desired by some workers and, opponents claim, could result in unsafe or unhealthful working conditions.

REVENUES

This category presents 35 options for increasing revenues from federal taxes. The first four options concern increases in individual and corporate income tax rates. REV-05 through REV-07 discuss taxes on consumption, including a new general tax, new or increased taxes on energy, and extensions or increases of existing excise taxes.

Most of the options suggest ways to broaden the base of the income tax, by reducing or eliminating the revenue losses stemming from tax preferences. REV-08 and REV-09 would reduce investment tax preferences that were created to encourage capital formation generally. REV-10 through REV-19 would alter tax preferences aimed at particular industries or activities. REV-20 through REV-26 would reduce preferences that make some forms of saving more attractive than others. The remaining options for broadening the income tax base (REV-27 through REV-31) concern tax preferences that do not affect savings or investment.

Other options include REV-32, which is aimed at improving compliance with income tax laws, REV-33 and REV-34, which describe ways to reduce most tax preferences through across-the-board percentage cuts or by imposing minimum taxes, and REV-35, which describes a way to reduce the revenue loss attributable to the foreign tax credit.

The estimates of revenue gains from all of the options were made relative to the CBO baseline budget forecast. The baseline is developed under the assumption that most provisions of the tax code that are currently scheduled to expire will not be extended. If, however, tax preferences scheduled to expire were extended, there would be serious budgetary consequences--a loss of $45.1 billion in 1986-1990 relative to the CBO baseline. These tax preferences and other provisions scheduled to expire are described in CBO's report, *The Economic and Budget Outlook, Fiscal Years 1986-1990*, p. 51.

REV-01 RAISE MARGINAL TAX RATES FOR INDIVIDUALS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Raise Marginal Tax Rates 10 Percent	21.1	31.1	32.1	33.1	34.2	151.6
Raise Marginal Rates 10 Percent on Income in Excess of $100,000 for Joint Filers, $70,000 for Single Filers	2.2	5.9	6.5	7.3	8.2	30.1

Under the current income tax structure, marginal tax rates range from 11 percent to 50 percent. (The marginal rate is the rate of tax that a person must pay on an extra dollar of income.) A 10 percent across-the-board increase in marginal tax rates would raise them to between 12 percent and 55 percent and increase revenues by $151.6 billion between 1986 and 1990. As an alternative, if policymakers wished to increase revenue without raising taxes for low- and middle-income taxpayers, the marginal rate increase could be limited to income in excess of some specified level. For example, a 10 percent increase in marginal tax rates on income in excess of $100,000 for joint returns ($70,000 for single returns) would increase revenues by $30.1 billion between 1986 and 1990.

The main advantage of increasing marginal tax rates is that it can raise a significant amount of money quickly and easily. Raising tax rates is quite simple mechanically and straightforward administratively. Because the bulk of the income tax is collected in the form of payments withheld by employers from employee paychecks, the added revenue would begin to flow into the Treasury as soon as employers amended their payroll accounting practices (usually in one to three months).

A rate increase may have undesirable effects, however. Marginal tax rates confronted by most taxpayers are fairly high, compared to historical levels, despite the reductions in marginal tax rates enacted in 1981. High marginal rates are believed to discourage working, saving, and investing, and any increase in those rates would probably discourage these activities to an even greater degree.

Higher tax rates would also exacerbate economic distortions resulting from provisions that discriminate among sources and uses of income. These provisions reduce economic efficiency by biasing the allocation of resources toward tax-favored activities. Increases in tax rates on those in the top brackets can especially distort savings and investment decisions.

In addition to their economic costs, tax rate increases may be perceived as unfair because they most heavily affect people who are already paying taxes, especially those taxpayers who now pay at high rates. Taxpayers who are able to reduce their tax bill (or escape taxation altogether) by taking advantage of special provisions of the law are significantly less affected (or not affected at all).

REV-02 AMEND OR APPEAL INDEXING OF INCOME TAX RATES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Repeal Indexing	5.3	15.5	27.9	42.1	58.5	149.3
Delay Further Indexing Until January 1, 1987	5.3	8.7	9.4	10.1	10.9	44.4
Index for Inflation in Excess of 3 Percent	4.3	11.6	20.1	30.0	41.5	107.5

This year, for the first time, the rate structure of the individual income tax is indexed to offset the effects of inflation. The personal exemption and the boundaries of each statutory tax bracket (including the zero bracket amount) have been increased 4.08 percent to reflect the change in the Consumer Price Index experienced last year. A similar adjustment will be made each year.

Many proposals have been suggested to repeal or reduce the effects of indexing. Ideas range from outright repeal, to delay of indexing, to partial indexing for inflation above some threshold rate only. The additional revenues that would result from three of the most commonly discussed proposals are shown above.

Changes in indexing would gain smaller amounts of revenue in their first year of enactment but would raise considerably larger amounts in future years because of the cumulative effects of indexing. The significant reduction in the deficit, especially in later years, is one of the main arguments in favor of cutting back on indexing.

Another advantage of amending or repealing indexing is that it would not single out any particular group of taxpayers, but rather would apply to everyone by changing the tax structure across the board. Additionally, it would be easy to carry out administratively. Repeal or delay of indexing could be accomplished simply by not changing the tax structure for one or more years. Indexing for inflation in excess of a specified rate would be done precisely as indexing is done now, except that a smaller percentage change would be applied to the exemption amount and the bracket boundaries.

Those proponents of an unindexed tax structure who believe that fiscal policy should have a role in smoothing out fluctuations in aggregate demand suggest that an unindexed system would have a beneficial anti-inflation effect: it would tend to increase taxes and thus might help to cool off the economy when demand was growing too rapidly. The tax increase would occur automatically and quickly, thereby avoiding the difficult and lengthy debates that generally occur when discretionary tax increases are contemplated. Periodic rate cuts would then be necessary to keep tax increases from outrunning increases in real income. While, in theory, those rate cuts could be timed for years when the economy was relatively weak, critics of using fiscal policy to "fine tune" the economy argue that it is very difficult to time such actions appropriately.

Arguments against changing indexing are both economic and political. In economic terms, reducing indexing would increase marginal tax rates for many taxpayers by allowing inflation to move them into higher tax brackets even when their incomes in constant dollars were unchanged. Therefore, it would reduce economic efficiency to the extent that higher marginal tax rates affect decisions about work effort and savings. At the same time, the incentive effects of reducing indexing would not be exactly the same as for explicit across-the-board increases in marginal tax rates, because taxpayers in the 50 percent bracket would not experience an increase in their marginal tax rate, even though their real tax burden would rise.

The revenue gains from either complete elimination of indexing or delay of indexing for one year would be highly sensitive to inflation; for higher rates of inflation, the revenue increase from eliminating indexing would be greater. (This also means that, in the absence of indexing, average tax rates paid by individuals would rise much faster if inflation increased.) On the other hand, the revenue pickup compared to current law from indexing for inflation in excess of 3 percent would be less sensitive to changes in inflation (unless inflation fell below 3 percent) and taxpayers would still be protected from the effects of increases in the rate of inflation.

On political grounds, proponents favor indexing because it requires the Congress to decide explicitly on tax increases. Without indexing, inflation causes more-than-proportional increases in tax liabilities as incomes rise. This results in increased real tax burdens without legislative action even though real income increases may not have occurred. In contrast, indexing forces the Congress to enact tax rate increases if it wants to increase the ratio of federal spending to GNP.

The tax increases resulting from elimination of indexing would have very specific and somewhat arbitrary distributional effects. The proportionate increase in tax burden would be greater for nonitemizers than for itemizers because nonitemizers lose the benefit of an indexed zero bracket amount. Since nonitemizers usually have less income than itemizers, this means the proportionate increase in the tax burden would generally fall as income rose. For example, if indexing was eliminated, the tax burden of a four-person family with $10,000 in income in 1985 (projected to rise to $14,300 in 1990) that does not itemize would be increased by 56 percent in 1990, while the tax burden of a similar family with $50,000 of income that claims itemized deductions equal to 23 percent of income would be increased by 18 percent. On the other hand, the proportionate reduction in after-tax income would rise as income rose. The tax increase resulting from the elimination of indexing would reduce after-tax income in 1990 by 2.2 percent for the above four-person family with income of $10,000 and by 3.3 percent for the four-person family with income of $50,000.

REV-03 IMPOSE A CORPORATE SURTAX

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Surtax on Tax before Credits						
10 Percent	6.6	11.8	12.7	13.4	14.0	58.5
5 Percent	3.3	5.9	6.4	6.7	7.0	29.3

Imposing a corporate surtax has recent historical precedent. As a temporary measure to help pay for the Vietnam War, a surtax was imposed on individual and corporate taxes from January 1, 1968, to December 31, 1969, at the annual rate of 10 percent, and from January 1, 1970, to June 30, 1970, at the annual rate of 5 percent. For most corporate taxpayers, a 10 percent surtax comparable to the Vietnam War surtax would be equivalent to raising the marginal statutory tax rate 4.6 points--from 46 percent to 50.6 percent. A 5 percent surtax would be equivalent to raising the statutory tax rate 2.3 points, to 48.3 percent.

A surtax is a relatively simple means of raising a significant amount of revenue quickly, and in a way that may be labelled as temporary. Proponents of a surtax on individual incomes generally include a corporate surtax at the same rate on grounds of equity. The principal objection to a surtax is that it increases the tax burden most for those who already pay the most taxes. This objection is especially pertinent in the case of the corporate income tax, which, in its present form, results in widely differing effective tax rates, both across and within industries. Moreover, if the surtax was temporary, provisions in current law that allow deferrals of taxable income, such as accelerated depreciation, could become forgiveness rather than deferral of surtax liability. This would further increase the value of these tax preferences.

If the tax change is to be permanent, a corporate surtax on a broader definition of income could raise the same revenue with a lower rate, and would increase the neutrality of the tax system instead of reducing it (see REV-34).

REV-04 REPEAL THE REDUCED RATES ON THE FIRST $100,000 OF CORPORATE INCOME OR PHASE OUT THE BENEFITS FOR TAXABLE INCOMES ABOVE $100,000

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Repeal Lower Rates	5.1	8.7	9.0	9.3	9.6	41.7
Phase Out Above $100,000	0.6	1.1	1.1	1.2	1.2	5.2

Under current law, taxable corporate income is generally subject to a flat tax rate of 46 percent, but the first $100,000 of taxable income is subject to the following schedule of rates:

Taxable Income (dollars)	Marginal Tax Rate (percent)
0 to 25,000	15
25,000 to 50,000	18
50,000 to 75,000	30
75,000 to 100,000	40

Compared to a flat 46 percent rate, the graduated rates provide a tax benefit equal to $20,250 on the first $100,000 of taxable corporate income. As part of the Deficit Reduction Act of 1984, this tax benefit is reduced by 5 cents per dollar for taxable income in excess of $1 million, thereby eliminating the benefits of the graduated rates for corporations with income in excess of $1,405,000.

The lower graduated rates are intended to provide tax relief for smaller businesses and to reduce the disparity in taxes paid by corporations and by noncorporate businesses that are taxed under the individual income tax. Critics oppose these rates as being inefficient in achieving this objective because the rates are fully available to all corporations with taxable income below $1 million, even though the top marginal rate is reached at a taxable income of $100,000. In addition, there is generally no relationship between the size of a corporation and the income (or wealth) of its shareholders. Small corporations are often owned by high-income taxpayers who take advantage of the lower rates. These taxpayers usually have the option of paying tax at ordinary individual income rates on income received from domestic corporations having no more than 35 shareholders. Most of these corporations can elect to be Subchapter S corporations, which are essentially taxed as partnerships and pay no separate corporate tax. Thus, the benefits of the reduced rates do not necessarily accrue to lower-income taxpayers.

Repeal of the lower corporate marginal rates would raise $5.1 billion in 1986, and $41.7 billion between 1986 and 1990. Decreasing the benefits of reduced corporate tax rates beginning at $100,000 of taxable income instead of $1 million would preserve the favorable treatment for the smallest corporations, while still raising $0.6 billion in 1986, and $5.2 from 1986 through 1990.

REV-05 IMPOSE A VALUE-ADDED OR NATIONAL SALES TAX

Addition to CBO Baseline a/	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
5 Percent Tax, Comprehensive Base	--	60.4	104.0	111.6	119.5	395.5
5 Percent Tax, Narrower Base, Exemptions for Food, Housing, and Medical Care	--	38.7	66.5	71.3	76.4	252.9
5 Percent Tax, Narrower Base, No Exemptions for Food, Drugs, and Medical Care; Low-Income Relief Under Food Stamps and Medicaid b/	--	50.5	87.1	93.4	100.0	331.0

a. Estimates based on effective date of January 1, 1987.

b. Includes increased outlays for Medicaid and Food Stamps.

A national value-added or retail sales tax could raise substantial revenue at relatively low tax rates. A common way of administering a value-added tax is to collect a tax on the total value of final sales of all firms, but allow them to claim a credit for taxes paid on goods purchased from other firms. Creditable purchases include those of natural resources (including energy), intermediate materials, and capital goods. Wages, salaries, profits, and interest are not creditable because they have not been previously taxed; these components represent the "value added" by a firm.

A value-added tax is essentially equivalent in economic effect to a national retail sales tax. Either type of tax could be fully comprehensive, or could allow exemptions for certain goods and services. In addition to exemptions for charitable, religious, and educational institutions, the tax might allow exemptions for necessities thereby reducing the regressivity of the tax. These might include food consumed at home, all housing, and medical services, among others. Ease of administration might also justify exemptions for items such as the imputed value of services of financial institutions, the imputed rent from owner-occupied housing (though sales of new homes could be taxed), and sales by small businesses and farms.

Arguments for a VAT or retail sales tax are that it could raise a significant amount of revenue with low rates and that it would be more neutral among economic activities than an equal revenue increase in income tax rates. In addition, a VAT or retail sales tax would be basically neutral between present and future consumption, and therefore would probably not adversely affect incentives for saving and investment as much as an equal increase in income taxes. (Like an income tax, however, it would reduce rewards from work effort.) Finally, there is some evidence from public opinion polls that the public regards increases in sales taxes as a fairer way of raising revenue than increases in the income tax.

The major argument against a national sales tax is that it is regressive because it must be imposed at a flat rate and because the ratio of consumption to income falls for persons in higher income classes. (The regressivity of a sales tax may be overstated, however, by using current rather than permanent income as a measure of ability to pay.) Other arguments against a national sales tax are that it could cause an increase in the price level when introduced, which might have further inflationary repercussions, and that states would regard a federal sales tax as interfering with their traditional revenue base. Finally, a federal sales tax would require new enforcement procedures and additional IRS personnel and might take one or two years to implement fully; it therefore should not be considered unless one intends to raise a significant amount of revenue. The revenue-raising potential of a federal sales tax is, however, itself a concern among those who fear it might facilitate undue growth of the federal government.

The regressivity of a value-added tax could be alleviated by exemptions for goods and services consumed by low-income persons. Exemptions under a VAT or retail sales tax, however, could substantially increase costs of enforcement and compliance, especially over time as new items considered worthy of special treatment are added to the list. An alternative or supplementary approach to offsetting regressivity is to allow additional exemptions or credits for low-income persons under the federal income tax.

The derivation of two tax bases for a VAT are shown in the accompanying table. The first base is as broad as possible, excluding only those items that would be administratively very difficult to include. The second adds exemptions for food, health care, and other expenditures. For 1983, the comprehensive base is equal to $1.9 trillion, while the more narrowly defined base amounts to $1.3 trillion.

A 5 percent tax on the comprehensive VAT base would raise an estimated $60.4 billion in fiscal year 1987 and $395.5 billion over the 1986 to 1990 period, after allowing for reduced personal and corporate income taxes. (Personal and corporate taxes would be reduced by a VAT because the tax would reduce personal and corporate incomes, assuming nominal GNP remained constant.) The narrower VAT would raise $38.7 billion in fiscal year 1987 and $252.9 billion between 1986 and 1990.

A third option would be to add food, drugs, and medical care (health insurance and hospital) to the narrower tax base, but to provide low-income relief through higher Medicaid and food stamp payments. Medicaid payments would be subject to the VAT and could automatically be adjusted to reflect the new tax. A 10 percent increase in food stamp benefits would compensate low-income persons for taxes on food, as well as partially offset taxes on other purchases. Overall, this option would raise $50.5 billion in net revenues in 1987, and $331 billion in the years 1986 through 1990.

CALCULATION OF TAX BASE UNDER A VAT, 1983

Items Included		Amount (In millions of dollars)	Gross Tax at 5 Percent Rate (In millions of dollars)
Total Personal Consumption in GNP		2,155,920	
Less:	Rent on Housing	363,318	
	Net Foreign Travel Expenditures	8,609	
	Religious and Welfare Activities	32,166	
Plus:	Monetary Interest Paid by Individuals	65,062	
	New Residential Construction	127,638	
Comprehensive VAT Tax Base		1,944,527	97,226
Possible Exemptions			
	New Residential Construction	127,638	
	Medical Care: Health Insurance and Hospitals	118,215	
	Drugs	21,575	
	Food Purchased for Off-Premise Consumption	293,678	
	Food Furnished Employees	6,370	
	Clothing Issued to Military Personnel	127	
	Domestic Services	7,768	
	Free Financial Services	50,985	
	Expense of Handling Life Insurance	23,375	
	Local Transit (ex. Taxis)	3,868	
	Clubs and Fraternal Organizations	2,955	
	Private Education and Research	33,313	
Narrower VAT Tax Base		1,254,660	62,733

SOURCE: Advisory Commission on Intergovernmental Relations, *Balancing Federal Revenue Needs with State-Local Interests*, forthcoming.

REV-06 INCREASE ENERGY TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Impose Tax on Domestic and Imported Oil ($5 per barrel)	14.8	21.6	21.9	22.2	22.5	103.0
Impose Oil Import Fee ($5 per barrel)	6.6	9.5	9.1	9.4	9.8	44.4
Impose Excise Tax on Natural Gas ($1 per 1,000 cubic feet)	9.2	13.2	13.3	13.4	13.4	62.5
Increase Motor Fuel Excise Tax (12 cents per gallon)	7.4	10.5	10.3	10.2	10.1	48.5
Impose Broad-Based Tax on Domestic Energy Consumption (5 percent of value)	9.8	14.8	15.9	17.0	18.3	75.8

NOTE: These added revenues are net of any estimated changes in income, windfall profit, and other taxes that might result from each option. Induced outlay effects are not estimated.

Energy taxes could raise significant amounts of revenue, reduce the country's dependence on foreign oil suppliers, and increase conservation by making energy more expensive. The United States depends on foreign sources for about 32 percent of the oil it consumes, and about 12 percent of its total energy. This dependence involves risks to the U.S. economy--the most dangerous being potential supply disruptions and their economic and political consequences. Reducing energy consumption by raising energy taxes might reduce the costs of supply interruptions and increase the flexibility of U.S. foreign policy. A portion of the tax might be shifted to foreign suppliers if reduced U.S. demand lowered world oil prices.

Energy taxes would probably also increase conservation efforts (over and above those consistent with world energy prices), thereby prolonging the availability of this country's nonrenewable energy resources. Further, some have favored taxes on domestic energy producers as a means to capture some of the windfall profits or rents associated with high energy prices.

Concern has been expressed over the use of energy taxes, on several grounds. Because energy taxes might raise energy prices, they might more heavily burden low-income taxpayers who spend a relatively high percentage of their income on energy. Moreover, energy taxes could have widely different effects on firms and households in different parts of the country. In addition, to the extent that the imposition of energy taxes might raise the Consumer Price Index, indexed federal outlay programs would be affected. Finally, some observers have argued that alternative policies, such as stockpiling, are more cost-effective ways of relieving dependence on imports than policies artificially depressing current energy use by households and businesses, and that, for the rest, free markets provide sufficient incentives for resource conservation.

Five different energy taxes with varying economic and budgetary effects are considered below.

Impose Excise Tax on Domestic and Imported Oil. An excise tax on all oil--both domestically produced and imported--could raise substantial revenue. In its budget for 1984, the Administration proposed a $5-per-barrel contingency tax on both domestic and imported oil starting in 1986. A $5-per-barrel tax would raise about $22 billion per year and would equal about 18 percent of the price of a barrel of oil or 12 cents per gallon of gasoline.

Since 1981, the cost of a barrel of oil has declined from $35 to $28, a reduction in real terms of about 31 percent. A comprehensive tax on oil would raise prices to consumers, thereby increasing conservation efforts and reducing consumption, but could still leave prices below 1981 levels. Prices received by domestic oil producers would decline in the short run. They possibly would also decline in the long run if the resulting drop in demand for imported oil by the United States were to lower world prices. In contrast, prices received by producers of alternative sources of energy (natural gas, coal) would rise, encouraging additional production.

Impose Oil Import Fee. As an alternative to a broad excise tax on all oil, the Congress could limit the tax to imports of crude petroleum and petroleum products. An oil import fee of $5 per barrel would raise about $9 billion per year. About one-quarter of that amount would come from higher oil windfall profit taxes, since an import fee would allow the price of all domestically produced oil to increase, thereby increasing the windfall "profit" and tax on each barrel.

An oil import fee, like a tax on all oil, would serve to maintain conservation incentives by pushing up the price for all imported and domestically produced energy sources. Moreover, an oil import fee could be an appropriate source of revenue for the Strategic Petroleum Reserve, insofar as the Reserve is designed to reduce the potential consequences of oil supply interruptions. Unlike a tax on all oil, however, an oil import fee would provide an incentive to increase domestic production of oil, because the fee would raise the profitability of domestic production. These effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased as U.S. energy sources were depleted faster.

With the world price of oil currently at about $28 per barrel, the $5 fee would still leave the total price of oil below its $35-per-barrel price in 1981. Furthermore, if there were excess supplies of crude oil on the world market, part of the fee would be borne by foreign suppliers. One consequence of this, however, is that an oil import fee might cause political problems with some important U.S. trading partners. Attempts to mitigate these problems by exempting historical levels of imports from selected nations such as Canada, Mexico, and the United Kingdom would substantially reduce its revenue potential.

Impose Excise Tax on Natural Gas. Price controls on most domestically produced natural gas were lifted on January 1, 1985, under the terms of the Natural Gas Policy Act of 1978 (NGPA), though an estimated 35 percent to 40 percent will remain regulated and subject to price controls. Economists generally agree that price controls lead to an inefficient allocation of natural gas. Below-market prices for some categories of gas will tend to make producers shift their production from controlled to decontrolled gas. To the extent that decontrolled gas is more costly to produce, resources are wasted from these production shifts. In addition, below-market prices encourage some consumers to use more gas than they would otherwise.

To a large extent, the current misallocations in the natural gas market could be reduced if all gas were decontrolled. Full decontrol of all natural gas, however, could result in large windfall profits for producers of gas still under price controls. (The average wellhead price for all gas is about $2.80 per 1,000 cubic feet, but is $1.50 for price-controlled gas.) The Congress might want to tax this windfall as it did that on oil. Depending on how it was structured, such a tax could raise $5 billion in the first full year. To the extent that windfall profits from the decontrol of gas were temporary, such a tax would provide only a short-term reduction in the deficit. Moreover, taxing the profits of gas producers could reduce any potential supply reallocation gains accruing to decontrol.

An alternative that would raise revenue on a long-term basis would be a simple excise tax on natural gas, unrelated to any calculation of windfall profits. An excise tax of $1.00 per 1,000 cubic feet, for example, would raise about $13 billion annually. The current price of residential natural gas is about $6.00 per 1,000 cubic feet, so that if the tax were fully passed on to consumers the price rise would be about 17 percent. Such an excise tax would encourage conservation of gas or conversion to oil, coal, or other fuels. To the extent that gas users shifted to oil, however, dependence on imports could increase; and while switching to coal would avoid increasing oil consumption, it might impose additional environmental costs. Therefore, a tax on natural gas might not be consistent with other energy policy goals.

Impose Additional Motor Fuel Excise Tax and Allocate Revenues to General Fund. The Surface Transportation Assistance Act of 1982 increased the federal tax on gasoline and other highway motor fuels by 5 cents per gallon in April 1983; it had been 4 cents per gallon since 1959. This increase did not reduce the federal deficit, however, because expenditures on construction and improvement of highways, bridges, and mass transit facilities were increased at the same time. State governments also impose gasoline taxes ranging from 7 to 18 cents per gallon.

An additional federal excise tax on motor fuels would raise about $0.9 billion per year for each cent of tax and would reduce the deficit if the revenue was dedicated to the general fund instead of being used to expand transportation outlays by making more revenues available to the highway trust fund. Because the average national price of gasoline has dropped from a peak of about $1.39 a gallon in March 1981 to about $1.17 in December 1984, an additional tax of 12 cents per gallon would not put the total cost of gasoline above what consumers have already experienced. Compared to other countries, many of which levy taxes of well over $1.00 a gallon, the United States charges one of the lowest tax rates on motor fuel.

Beyond raising revenue, an additional motor fuel excise tax would reduce consumption of gasoline and diesel fuel and dependence on foreign oil by encouraging people to drive fewer miles or purchase more fuel-efficient cars and trucks. The excise tax would probably not significantly affect oil consumption for other purposes, such as electricity production or home heating. Arguments against such a tax are that it would be regressive and would impose an unfair burden on some households.

Impose Broad-Based Tax on All Energy. Instead of placing selective excise taxes on various types of energy, the Congress could impose a broad-based tax on all forms of energy consumption. This tax would apply to most energy sources and cover both domestic and foreign suppliers. A national energy tax would heighten conservation incentives and reduce consumption of all forms of energy. It would probably neither decrease oil consumption as much as an oil import fee or an oil tax of equal revenue, nor provide significant incentives for consumers to switch to forms of energy other than oil. A 5 percent tax on the value of all domestic and imported energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise about $15 billion per year in revenues. Further, because the tax would apply to all energy sources, it could raise much more revenue at a lower rate than others above.

A national energy tax could be based either on units produced (such as barrels of oil, tons of coal, or cubic feet of gas) or on the heat content--in British thermal units--of the fuel (Btu tax). Depending on how the tax was structured, the relative prices of the various forms of energy could either be left unchanged or substantially altered. For example, a uniform Btu tax would raise the price of coal by a larger percentage than that of oil or natural gas, because a dollar's worth of coal currently buys more Btus. (Coal sells for about one-quarter of the price of oil per Btu.) A national tax on energy could be collected at the point of production or importation, or at the wholesale level if that was administratively more convenient.

REV-07 INCREASE EXCISE TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Extend DEFRA Increase of Telephone Excise Tax	--	--	1.4	2.5	2.6	6.6
Extend TEFRA Increase of Cigarette Excise Tax	1.5	1.7	1.7	1.7	1.7	8.3
Double Excise Taxes on Beer & Wine	0.8	1.1	1.2	1.2	1.2	5.5
Increase Excise Taxes on Distilled Spirits	1.1	1.6	1.6	1.6	1.6	7.5
Index Current Cigarette and Alcohol Excise Tax Rates for Inflation	0.2	0.5	0.8	1.1	1.5	4.1

The major federal excise taxes (other than those levied on gasoline, air travel, and windfall oil profits) are on alcohol, tobacco, and telephone use. Additional revenues could be raised by extending the temporary increases in the tobacco and telephone excise taxes, and by increasing alcohol excise taxes.

Extend DEFRA Increase of Telephone Excise Tax. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised the excise tax on local and long-distance telephone service and teletypewriter exchange service to 3 percent for calendar years 1983 through 1985. The Deficit Reduction Act of 1984 (DEFRA) extended the 3 percent rate through calendar year 1987. Extending the tax beyond 1987 at the 3 percent rate would raise net revenues by $6.6 billion over fiscal years 1988-1990.

Arguments for extending the tax are that it has had no discernible adverse impact on the growth and competitiveness of the industry; that it is a broad-based tax since virtually all households have telephones; and that the cost to the government of administering the tax is low. Arguments against extension are that the tax is regressive; that its impact on business firms is arbitrary, burdening them in proportion to their use of telephones; and that it may limit expansion and innovation in the telecommunications industry.

Extend TEFRA Increase of Cigarette Excise Tax. The Tax Equity and Fiscal Responsibility Act of 1982 increased the excise tax on cigarettes from 8 cents per pack to 16 cents for the period from January 1, 1983, to September 30, 1985. Extending this increase would add about $1.7 billion dollars a year to federal revenues net of reduced income taxes. The 16 cent federal tax represents less than 20 percent of the current average market price (including tax) per pack, significantly less than the 37 percent of the price that the 8 cent tax represented when it was set in 1951.

The TEFRA increase could be seen as compensation for the social costs of smoking, including medical costs that society in general ultimately bears. (Logically, increased cigarette tax revenue could be earmarked to the Medicare trust fund.) The tax might also discourage smoking to a limited degree by raising prices, with its greatest impact probably on the young. On the other hand, the tax is regressive, discriminates against certain groups of consumers, and might have an adverse affect on state and local revenues from cigarette taxes.

Increase Taxes on Alcoholic Beverages. The tax on distilled spirits was increased by DEFRA to $12.50 per proof gallon effective October 1, 1985. This marks the first increase in the tax rate on distilled spirits since 1951 when it was set at $10.50 per proof gallon. In 1951, $10.50 per proof gallon represented 43 percent of the average product price; by comparison, $12.50 per proof gallon represents 27 percent of the average current price. Increasing the tax to $21.00 per proof gallon would raise $7.5 billion in revenues (net of reduced income taxes) over the 1986-1990 period and still leave the tax rate as a percentage of average product price slightly below the tax rate in effect in 1951.

Nondistilled beverages--beer and wine--were unaffected by DEFRA and are thus still taxed at the per-unit rates in effect since 1951. Doubling beer and wine excise taxes would raise about $5.5 billion in net new revenues over the 1986-1990 period. It may be desirable to coordinate the taxes on different alcoholic beverages, either in terms of the percentage of retail cost or the tax per unit of alcohol. Currently, beer and wine are both taxed significantly more lightly than distilled spirits relative to both value and alcohol content, with wine receiving the most favorable treatment.

Increased taxes on alcoholic beverages would bring the tax rates into line with historic rates, and would help to offset the social costs of drinking (such as those from alcoholism and alcohol-related automobile accidents). On the other hand, it can be argued that increases would make tax rates on alcoholic beverages unjustifiably higher than those on other goods that impose social costs. In addition, alcohol taxes are regressive, and increases in the federal tax rates would interfere with a tax base tapped by many of the states.

Index Cigarette and Alcohol Tax Rates for Inflation. When taxes are set on a per-unit basis, the tax as a percentage of value will fall as inflation boosts the value of the taxed product. As a result, inflation reduces the real burden of unit taxes over time. Indexing tax rates to the Consumer Price Index (or specifically to a price index for the taxed product) would insure that tax revenues kept pace with inflation. Indexing current cigarette and alcohol tax rates to the CPI would raise $4.1 billion in net revenues over 1986-1990.

Indexing of specific excise taxes would prevent inflation-induced erosion of tax receipts in a gradual and predictable manner, thereby reducing the impact of abrupt increases in unit rates on consumers, state and local governments, and businesses. On the other hand, to the extent excise taxes are regarded as poor ways to raise revenue, failure to index them is one way to allow their relative burden to decline over time.

An alternative to indexing would be to convert the unit taxes to ad valorem taxes (set as a percentage of value); this would accomplish the same objective of tying tax revenues to price increases, although revenue would be tied to the prices of the taxed goods, not the general price level. Ad valorem taxes would, however, be administratively more complex because of the need to impute manufacturers' prices when the goods are sold by manufacturer-controlled wholesalers and retail outlets.

REV-08 REVISE DEPRECIATION RULES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Revise Depreciation Rules	0.6	-0.1	3.0	10.9	21.2	35.5
Revise Depreciation Rules and Repeal Investment Tax Credit	15.5	28.4	36.6	50.0	65.5	196.0

NOTE: These revenue estimates are for a constant-rate depreciation system with allowable depreciation rates as explained in the text.

Under current law, capital assets are depreciated under schedules provided for by the Accelerated Cost Recovery System (ACRS). This system assigns each asset to one of five groups: most machinery and equipment are assigned to the three- or the five-year depreciation class; most public utility property is placed in the 10- or 15-year public utility class; and most buildings are assigned to the 18-year real property class. Equipment and machinery are also eligible for the investment tax credit: assets in the three-year class qualify for a 6 percent credit; assets in the five-year and public utility classes qualify for a 10 percent credit. Buildings are not eligible for the investment tax credit.

The current capital recovery system (consisting of the combination of ACRS and the investment tax credit) has been criticized because it is not neutral among various types of assets and because it facilitates tax shelter activities. Specifically, some critics charge that because effective tax rates on different classes vary widely, investment decisions are driven by tax considerations and not strictly by the market, thereby resulting in an inefficient allocation of scarce capital. As a result, it is said that corporations invest too much in lightly taxed equipment and machinery and too little in more heavily taxed buildings. The table below shows effective corporate tax rates for several types of assets. The table shows that current law significantly favors equipment over structures, as indicated by their much lower effective tax rates.

EFFECTIVE CORPORATE TAX RATES ON ASSETS UNDER CONSTANT RATE DEPRECIATION (CRD)

Asset Class	ACRS Class (years)	CRD Class Life (years)	Real Effective Tax Rates: Current Law ACRS (percent)	ACRS No ITC (percent)	ACRS Full Basis Adjustment (percent)	CRD (percent)
Automobiles	3	4	-12.6	38.1	4.0	33.6
Computers	5	6	-8.5	48.7	10.8	41.0
Heavy Trucks	5	6	-8.0	47.2	10.2	39.5
Aircraft	5	10	-6.1	41.0	8.1	45.4
General Industrial Equipment	5	10	-4.5	34.2	6.2	38.4
Electrical Machinery	5	10	-4.4	33.7	6.1	37.8
Ships and Barges	5	18	-3.3	27.8	4.7	42.0
Engines and Turbines	10	18	18.3	39.5	22.7	42.6
Electric Light and Power	15	28	16.0	31.9	18.9	38.6
Telephone Plant	15	28	16.5	32.7	19.4	39.5
Industrial Buildings	18	40	37.5	37.5	37.5	44.3
Commercial Buildings	18	40	34.6	34.6	34.6	41.3

SOURCE: Congressional Budget Office.

NOTE: Taxes are computed under the assumptions of 100 percent equity financing, a 4 percent expected inflation rate, and a real rate of return of 6 percent net of the corporate taxes. The taxpayer is a corporation with a statutory marginal tax rate of 46 percent. Taxes paid by individual shareholders on dividends and capital gains are not counted in the calculation; the tax rate is the corporate level tax only.

In theory, effective tax rates under CRD should be about 46 percent. The tax rates shown here are less than 46 percent because the assumed rate of inflation (4 percent) is lower than when the CRD proposal was originally designed. Effective tax rates under current law are generally below 46 percent, but can be above 46 percent in cases where the acceleration of depreciation deductions fails to compensate for the effects of inflation on economic depreciation.

Another line of criticism notes that taxes on the return both to machinery and equipment and to buildings are lower than taxes on ordinary income because of the acceleration of depreciation deductions. This encourages the formation of tax shelters in real estate and equipment leasing. These tax shelter investments are often carried out by limited partnerships that create artificial tax losses for individuals through the combination of accelerated depreciation, interest deductions, and capital gains taxation of the proceeds of real estate sales.

The current system could be changed to approximate a neutral income tax by eliminating the investment tax credit and altering depreciation rules so that the present value of total depreciation deductions more closely resembled the present value of actual depreciation. Changes in depreciation rules to meet these objectives could be accomplished in a variety of ways. One option would be the Constant Rate Depreciation (CRD) system as proposed in the tax reform plan put forth by Senator Bill Bradley and Congressman Richard Gephardt. Under such a system, assets would be grouped into six classes, depending on their useful lives. For machinery and equipment, this determination would be made according to an asset's ADR midpoint life. (The ADR midpoint life is the midpoint of an asset's depreciable life under the Asset Depreciation Range System--the depreciation system that existed prior to the Economic Recovery Tax Act of 1981.) Real property would be placed in the highest ADR class. Within a given class, all assets, regardless of their acquisition date, would be grouped into one account. The account would be increased by the cost of new asset acquisitions and decreased by the amount of depreciation and any amounts received from the disposition of assets. The depreciation rates would be set for each account so that the present value of deductions would approximate the present value of economic depreciation at a 10 percent discount rate.

Under the CRD system contemplated in the Bradley-Gephardt proposal, assets would be assigned the following class lives:

ADR Midpoint (years)	Class Life (years)	Depreciation Rate (percent)
Under 5	4	62.50
5.0 to 8.5	6	41.67
9.0 to 14.5	10	25.00
15.0 to 24.0	18	13.89
25.0 to 35.0	28	8.93
35 and over and real property	40	6.25

The depreciation rate is determined by use of the 250 percent declining balance method applied to the class life.

A revision of the depreciation system to approximate economic depreciation would improve the allocation of capital among users by reducing disparities in effective tax rates among assets, and would reduce incentives to engage in tax shelter activities. The tax rates in the table above show that the tax system would be much more neutral among different types of assets under CRD than under ACRS. In addition, it would reduce discrimination against firms and industries (primarily firms suffering temporary losses, and start-up firms or firms with extraordinarily large capital expansion programs) that are unable to make full use of existing incentives because they lack the income or taxes from past investments required to offset newly earned deductions and credits.

If not accompanied by other provisions, however, such as lower corporate tax rates or relief of double taxation of corporate income, any lengthening of depreciation periods or reduction in investment credits could reduce overall investment. This, in turn, could limit the long-run growth of the economy. Credits and accelerated depreciation are also considered more effective than lower overall rates of tax in promoting specific types of investment.

REV-09 ELIMINATE INVESTMENT TAX CREDIT OR REQUIRE FULL BASIS ADJUSTMENT

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Eliminate Credit	14.5	28.0	32.3	36.0	39.4	150.2
Require Full Basis Adjustment	0.5	1.7	3.2	4.8	6.3	16.4

At present, taxpayers are allowed tax credits for certain investments--for example, general machinery and equipment or energy conservation equipment. These credits have the effect of reducing the cost of the equipment. The credit for machinery and equipment with a five-year life (which includes most equipment investment) is 10 percent, while the investment credit for three-year property (mainly R&D equipment, lightweight motor vehicles, and special tools) is 6 percent. In addition, firms are allowed to depreciate 50 percent of the investment tax credit; this is referred to as a 50 percent "basis" adjustment. Thus, for property receiving a 10 percent credit, firms can depreciate 95 percent of its cost (although they have only paid 90 percent); for property receiving a 6 percent credit, firms can depreciate 97 percent of its cost.

For three- and five-year property, the combination of the investment tax credit and current depreciation rules is about equivalent to an immediate write-off in present-value terms (assuming a 10 percent discount rate). This implies that the expected corporate tax rate on income from new three- and five-year property is about zero. By contrast, the combination of the investment tax credit and the Accelerated Cost Recovery System (ACRS) for 10- and 15-year public utility property and commercial and industrial buildings is much less generous. (Although public utility property is eligible for the investment tax credit, commercial and industrial structures are not.) Thus, the expected corporate tax rate on income from public utility property is about 15 percent and from commercial and industrial structures is about 35 percent. (See the effective tax rate table in REV-08.)

Two alternatives for narrowing the disparity in effective tax rates among assets would be to require a full (100 percent) basis adjustment for the credit (no depreciation of the credit), or to repeal the credit altogether. The full basis adjustment would raise the expected corporate tax rates on income from three- and five-year property to between 5 percent and 10 percent, depending upon the specific asset. Tax rates on income from public utility property would rise to about 20 percent; those on income from structures would remain at about 35 percent (see effective tax rate table). Requiring the full basis adjustment would raise revenues by $0.5 billion in 1986, and $16.4 billion over the 1986-1990 period.

Repealing the investment tax credit would result in a further convergence in expected corporate tax rates. This change would raise tax rates on three- and five-year property to between 35 percent and 50 percent, depending on the asset. The tax rates on public utility property would rise to between 30 percent and 35 percent; tax rates on commercial and industrial buildings would remain at about 35 percent. As shown in the effective tax rate table, this option would substantially lessen the divergence in effective corporate tax rates relative to current law. Repealing the credit would raise revenues by $14.5 billion in 1986, and $150.2 billion over the 1986-1990 period.

It has been argued that the current investment tax credit and ACRS are necessary incentives to encourage domestic investment in equipment and machinery, thereby increasing productivity and competitiveness in U.S. industry. The opposite case is that current tax law is too generous in its treatment of machinery and equipment compared with structures and inventories, and may distort decisions on investments; that is, it may lead corporations to invest too much in equipment and not enough in new plant and inventories. Requiring a full basis adjustment would partially reduce the current disparity in tax rates; repealing the credit would alleviate most of the tax distortion. (See REV-08 for changes in depreciation rules.)

REV-10 REDUCE INCENTIVES FOR BUILDING REHABILITATION

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Repeal the Rehabilitation Tax Credits	0.1	0.5	1.2	2.1	2.7	6.6
Limit Credits to Historic Renovations	0.1	0.4	0.7	1.1	1.4	3.7

The Congress has enacted large tax credits for amounts spent rehabilitating older income-producing buildings and has provided rapid amortization for rehabilitating low-income housing. These measures were designed to: encourage businesses to renovate their existing premises rather than relocate; encourage people to purchase and put to new use older buildings that have outlived their original purposes; promote the preservation of historic buildings; and increase the supply of low-income housing units. The rehabilitation tax credits range from 15 percent to 25 percent, depending on the age of the building and whether it is registered with the Department of the Interior as a historic structure. The rapid amortization for rehabilitating low-income housing permits depreciation of structures over a 5-year period, as opposed to the 15-year period permitted for new construction of low-income housing under the Accelerated Cost Recovery System. Repealing the rehabilitation credits would increase revenue by $0.1 billion in 1986 and $6.6 billion over the 1986-1990 period; retaining only a 15 percent credit for certified historic renovations would save $0.1 billion in 1986 and $3.7 billion in 1986-1990; increasing the amortization period for qualified low-income housing from 5 years to 15 years would save $0.1 billion in 1986-1990.

The main reason for repealing these incentives is that they tend to divert capital from more productive uses by favoring particular investments. In particular, the credits favor commercial use over most rental housing. Commercial buildings can qualify for the credit even if not in a historic district, but credits for rental housing are only available for historic buildings. All of these incentives favor renovation over new construction.

The argument for the credits is that the favored activities may have social benefits not reflected in market prices. The rapid amortization for low-income housing may reduce the amount of rent subsidy payments to poor families; the rehabilitation credit for older commercial buildings might stem the outflow of jobs from urban areas, and it discourages destruction of historically noteworthy or architecturally distinguished buildings. This latter objective, however, could be accomplished at lower cost by retaining a credit only for renovation of certified historic buildings. Preliminary surveys indicate a 15 percent credit would be sufficient to cover the extra costs of certification and historic-quality rehabilitation. In addition, limiting the credit to historic buildings would remove the incentive to convert older rental housing to commercial use.

REV-11 REPEAL PREFERENCES FOR FOREIGN SALES CORPORATIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	0.6	1.1	1.2	1.2	1.3	5.4

The Deficit Reduction Act of 1984 created a new vehicle for export incentives called Foreign Sales Corporations. An FSC is a foreign-incorporated subsidiary of a U.S. parent corporation and must meet certain foreign presence and processing requirements. Under the FSC provisions, a portion of the export income of an FSC is exempt from federal income tax. In addition, a domestic corporation is not taxed on dividends distributed from its FSC out of earnings attributable to foreign trade. This means there is no corporate-level tax on exempt foreign income of an FSC and only a single-level tax, at the FSC level, on the portion of foreign trade income that is not exempt. Repeal of FSC would increase revenues by $5.4 billion over the 1986-1990 period.

FSCs are designed to replace Domestic International Sales Corporations (DISCs), an export incentive in previous law. Under the DISC provisions, U.S. exporters were allowed to establish tax-exempt corporations (DISCs) that could defer tax on a specified percentage of their export income. The advantage of FSCs relative to DISCs is that they are less vulnerable to challenges by U.S. trading partners as violating international treaty provisions that prohibit members of the General Agreement on Tariffs and Trade from favoring exports over other domestic activities.

The main argument for repealing FSCs is that export subsidies reduce economic efficiency by diverting resources from more productive uses in domestic and import-competing industries to export activities that would be uneconomic without a subsidy. Moreover, since the adoption of flexible exchange rates in the 1970s, export subsidies do not necessarily reduce balance of payments deficits, because they tend to drive up the value of the dollar, leading to increased imports and reduced exports of nonsubsidized goods. Proponents of FSCs argue that increased exports help maintain employment in basic manufacturing industries and that U.S. firms are disadvantaged in world markets because of export subsidies by other industrialized nations. The Treasury Department has estimated that DISCs increased exports by between $5 billion and $8 billion annually at 1982 levels. This estimate does not take account, however, of offsetting reductions in exports and increases in imports that result from the effects of DISCs on foreign exchange rates. Finally, since the FSC provisions were enacted in 1984, it is unlikely that the Congress will want to reconsider them in 1985.

REV-12 REPEAL PERCENTAGE DEPLETION ALLOWANCE AND EXPENSING OF INTANGIBLE DRILLING, EXPLORATION, AND DEVELOPMENT COSTS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Repeal Percentage Depletion	1.3	2.2	2.3	2.4	2.6	10.9
Repeal Expensing of Intangible Drilling, Development, and Exploration Costs	2.9	4.5	4.0	3.6	3.4	18.3
Total	4.6	7.7	7.1	6.8	6.5	32.7

Mineral properties, such as oil and gas wells, coal mines, or gravel quarries, are similar to depreciable assets in that they require large "up front" expenditures to produce assets that generate future income. These capital costs for mineral property come in three types: costs associated with acquiring mineral rights and exploring for possible mineral deposits; development costs, including expenses such as those related to drilling oil wells or mine excavation; and costs for capital equipment, such as pumps or construction machinery. These costs are all treated differently under tax law.

Under current law, mineral acquisition costs are not immediately deductible (that is, may not be expensed), but must be "capitalized" and deducted in future years. In general, these capitalized costs are deducted over time through either cost or percentage depletion, unless the mineral rights prove worthless (in which case they are deductible in full at that time). Cost depletion allows firms to deduct costs according to the percentage of estimated reserves produced each year. For example, if 5 percent of a well's remaining reserves are produced in a given year, 5 percent of the well's unrecovered depletable costs are written off in that year. The total amount of cost depletion deductions allowed over time equals the total amount of capitalized costs.

Exploration costs of oil and gas producers are handled the same way as mineral rights acquisition costs. For all other mineral industries, such as coal or iron ore, exploration costs may be deducted immediately, but are subject to recapture once a mine is brought into production. (Recapture involves including exploration costs as income in the year the mine begins production.)

As an alternative to cost depletion, many taxpayers are allowed to use percentage depletion to compute their annual depletion deduction. Percentage depletion allows firms to deduct a certain percentage of the gross income from the property as depletion, regardless of the firm's actual capitalized costs. For example, nonintegrated oil and gas companies are allowed to deduct 15 percent of their gross revenue from their first 1,000 barrels per day of oil and gas production each year, regardless of their capitalized costs. (Integrated oil and gas producers are required to use cost depletion for recovering capitalized costs.) In addition, for other mineral properties, all producers are allowed to use cost depletion at varying statutory rates. Minerals eligible for percentage depletion include coal (10 percent), uranium (22 percent), oil shale (15 percent), gold (15 percent), and iron ore (14 percent). In the event that percentage depletion is less than cost depletion, the cost depletion deduction is allowed.

Mine development costs are deductible at the time of the expenditure. Oil and gas well-drilling costs are also immediately deductible, except in the case of integrated producers. Under the Tax Equity and Fiscal Responsibility Act of 1982, the Congress limited expensing for integrated oil and gas producers to 85 percent of intangible drilling costs; the remaining 15 percent was to be written off over a 36-month period. In the Deficit Reduction Act of 1984, this limitation was tightened to 80 percent of drilling costs. (This restriction applies only to producing wells; dry holes are expensed in full.) Nonintegrated producers are still allowed the full immediate deduction.

Capital machinery and equipment used in mineral operations is generally subject to the Accelerated Cost Recovery System (ACRS) and eligible for the investment tax credit. (Other mineral capital expenditures are not eligible for the investment tax credit.)

The current tax treatment of mineral properties has been criticized as being inconsistent with the traditional definition of income. This is because many of the preproduction expenses of mineral properties can be deducted faster than the value of the assets they "produce" declines. For example, drilling expenditures by oil companies produce assets (that is, producing wells) that decline in value as oil reserves are depleted. The tax code, however, allows firms to deduct these costs much sooner than indicated by the decline in the value of the underlying asset. Moreover, percentage depletion allows firms to deduct depletion in excess of their original investment. In fact, percentage depletion (in present-value terms) can be more generous than immediate expensing of all depletable costs.

The result of these provisions is that mineral producers face low effective tax rates, relative to statutory tax rates. The Congress might consider replacing the current set of provisions for mineral capital costs with a new system of cost recovery that required all expenditures on mineral rights, exploration, development, and drilling to be capitalized. All producers could be allowed the option of recovering these costs through the current provisions for cost depletion or amortizing them over 10 years (using the 250 percent declining balance method, switching to straight-line depreciation after six years). Expenditures on dry holes, unproductive mines, or worthless mineral rights could still be expensed. These provisions would raise the effective tax rate on mineral producers and remove a significant part of the tax subsidy now provided to firms in the mineral extraction business.

Proponents of repeal argue that the inherent subsidy provided by expensing and percentage depletion is not needed, especially in the oil and gas industry where prices have risen sharply over the last 12 years. As a result of these subsidies, too much capital is dedicated to extractive industries as opposed to other more productive uses. Moreover, it is argued that the differential taxation of integrated and independent oil companies is an inefficient way of promoting oil production.

The major argument for retaining the expensing and percentage depletion provisions is that they provide necessary incentives for increasing domestic production of oil, other fuels, and hard minerals. Furthermore, the oil and gas industry is highly risky, especially for small firms, and favorable tax treatment may be required so that firms can raise sufficient capital. Advocates also argue that many other forms of equipment and machinery now receive tax treatment that is at least as favorable as mineral capital investment, because of the substantial liberalization of depreciation allowances and investment tax credits. When compared with five-year ACRS property, expensing of development costs or percentage depletion may no longer provide any preferential tax advantage. Also, if account is taken of the windfall profit tax on oil, investment in the oil industry may even be relatively disadvantaged compared with other industries.

REV-13 ELIMINATE PRIVATE-PURPOSE TAX-EXEMPT BONDS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Mortgage Revenue Bonds						
Multiple Dwellings	0.1	0.2	0.4	0.7	1.0	2.3
Single-Family Homes	0.1	0.5	0.9	0.9	0.9	3.3
Industrial Development Bonds						
Small Issues	0.1	0.4	0.6	0.8	0.8	2.7
Pollution Control	a/	0.1	0.3	0.4	0.6	1.5
Other	a/	0.1	0.3	0.4	0.6	1.5
Student Loan Bonds	a/	0.1	0.2	0.3	0.4	1.1
Hospital Bonds	0.1	0.4	0.8	1.3	1.7	4.4
Total	0.5	1.9	3.6	4.9	6.0	16.9

a. Less than $50 million.

Tax-exempt bonds have long been a means for state and local governments to finance public investments, such as schools, highways, and water and sewer systems. In the past 20 years, however, state and local governments have issued a rapidly increasing volume of tax-exempt bonds to finance private-sector projects. These bonds make it possible for private businesses and individuals to borrow money at below-market interest rates. The low interest rates resulting from the bonds' exemption from federal taxation constitute a federal subsidy of the borrowing costs of private taxpaying entities. If current law remains in effect, revenue losses from all private-purpose bonds will amount to $14.5 billion in fiscal year 1986, rising to $20.7 billion in 1990. These bonds include mortgage revenue bonds for single-family homes and multiple dwellings; industrial development bonds (IDBs), which lower the borrowing costs of private firms for a wide variety of purposes; private hospital revenue bonds; and student loan bonds.

The federal government has tried for several years to control the growing use of tax-exempt financing for private purposes. Most recently, the Deficit Reduction Act of 1984 placed a state-by-state cap on the dollar volume of student loan and industrial development bonds. At the same time, however, it extended for four years the use of mortgage revenue bonds for single-family homes, which had been scheduled to expire at the end of 1983, and it extended the sunset date on small issue IDBs used for manufacturing to December 31, 1988. Tax exemption of new small issue IDBs used for any other purpose will expire on December 31, 1986.

Tax-exempt bonds are used to subsidize activities that the federal government might want to encourage, such as low-income multifamily housing, but they may also subsidize facilities where the arguments for additional federal assistance are weaker or nonexistent, such as private industrial plants. Even where a subsidy is warranted, tax-exempt bonds are a much less efficient form of subsidy than direct subsidies because the benefits are shared by the borrower of funds and the investor in tax-exempt bonds. Supporters of tax-exempt financing argue that inefficiency should not weigh heavily in situations where the Congress is unlikely to enact direct subsidy programs.

Mortgage Revenue Bonds. Mortgage revenue bonds provide below-market-interest financing for rental housing and single-family homes for low- and middle-income households. Under current law, states and localities can substitute mortgage credit certificates for single-family mortgage revenue bonds. If tax exemption of mortgage bonds for multiple dwellings issued after January 1, 1986, was eliminated, it would raise $2.3 billion over the 1986-1990 period. Under current law, the revenue losses from single-family mortgage bonds and mortgage credit certificates will amount to $0.1 billion in fiscal year 1986, rising to $0.9 billion in 1990. If mortgage credit certificates and tax exemption for mortgage revenue bonds were eliminated, the savings would amount to $5.6 billion over five years.

Industrial Development Bonds. IDBs include bonds for a variety of special purposes such as pollution control; airport and port facilities; industrial parks; and trade show and convention centers. They also include so-called "small issues," which may be used for a wide variety of purposes from manufacturing to farming, but cannot exceed $10 million. In 1984, small issue sales amounted to an estimated $16.9 billion; the volume of pollution control bonds amounted to $5.6 billion; bonds for other purposes amounted to $5.7 billion.

The use of all of these industrial development bonds has been controversial. The advocates of eliminating the bonds maintain that the large business tax cuts in the Economic Recovery Tax Act of 1981 reduced the need for interest-cost subsidies in general. In fact, the combination of tax-exempt financing, the investment tax credit, and depreciation benefits often results in deductions that exceed expensing for several classes of equipment, thus amounting to a negative tax on new investment. Supporters of the bonds argue that they promote economic development. Since industrial development bonds can be offered by all jurisdictions, however, their overall benefit to any community in attracting industry is largely cancelled out, with the result that the bonds represent a federal subsidy to business with no apparent gains for any locality. Eliminating IDBs issued for any purpose after January 1, 1986, would raise $5.7 billion over the 1986-1990 period. Eliminating the tax exemption for small issue IDBs only would raise $2.7 billion.

Student Loan Bonds. State agencies float student loan bonds to increase the amount of funds available for guaranteed student loans. The volume of the bonds rose from $0.1 billion in 1977 to $3.2 billion in 1983, and was $3.6 billion in 1984. Revenue losses from these bonds are estimated at $5.1 billion for the 1986-1990 period. Eliminating student loan bonds issued after January 1, 1986, would raise $1.1 billion over the same period. Other institutions, particularly private banks and the Student Loan Marketing Association, provide similar support without using tax-exempt bonds. In addition, student loans are federally guaranteed, which makes a student loan bond an unusually attractive investment. This is an exception to a general policy of not allowing tax exemption for federally guaranteed securities. Many states would argue, however, that private market financing has been inadequate, and that tax-exempt student loan bonds are needed to widen accessibility to higher education.

Hospital Bonds. Another issue in question is the use of tax-exempt bonds by nonprofit hospitals, which will account for a revenue loss of $2.4 billion in 1986, rising to $4.1 billion in 1990. Advocates of the bonds maintain that they lead to lower hospital costs; those who support eliminating the bonds question the need for any subsidy since the supply of hospital beds seems to be adequate. Eliminating the subsidy would raise $0.1 billion in 1986, rising to $4.4 billion over the 1986-1990 period.

REV-14 ELIMINATE SPECIAL CAPITAL GAINS TREATMENT FOR TIMBER, AND FOR COAL AND IRON ORE ROYALTIES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Timber Income	0.4	0.8	0.9	1.0	1.0	4.1
Coal and Iron Ore Royalties	0.1	0.1	0.2	0.2	0.2	0.8

The present tax code does not generally allow capital gains treatment for income from the sale or exchange of business inventories or the normal output of a business. In an exception to the standard treatment, some of the income associated with the production of timber, coal, and domestic iron ore, which would otherwise be taxed as ordinary income, is subject to special provisions that allow it favorable capital gains treatment. If the capital gains treatment of timber was repealed, it would add $4.1 billion to revenues from 1986 through 1990. Repeal of capital gains treatment of royalties from coal and domestic iron ore would add $0.8 billion to revenues over the 1986-1990 period.

Proponents of the special capital gains treatment of timber argue that timber producers should be given the same treatment available to farmers or suburban homeowners whose fields or homes bring higher prices because of their windbreaks or shade trees. If capital gains treatment for timber was ended, new rules would be necessary to determine when the gain from selling land with trees on it should be taxed as capital gains and when it should be taxed as ordinary income because the seller is in the business of timber production. While these rules would make the tax law more complex, there would also be some offsetting reduction in complexity because there would be no need for rules to distinguish between income from timber growing, which is currently treated as capital gain, and ordinary income from logging and manufacturing. Of greater importance is the fact that timber grown for the purpose of producing lumber or paper is no more a capital asset than wine or whiskey, which must be aged to achieve their full market value but are not treated as capital assets under current law.

Repealing capital gains treatment of timber would allow the market to determine how much timber should be produced. Proponents of special incentives for lumber production argue that market forces alone will not spur sufficient timber growing, because the production process is unusually long. They also hold that special treatment of timber income is justified on the grounds that it is in the national interest to promote development and conservation of timber resources. However, the goals of conservation and an assured supply of timber might be achieved more efficiently with direct incentives for planting and conservation of timberlands. Finally, one difficulty in eliminating the present tax-favored status is that owners of timberland would suffer large losses, since the present tax benefits have been capitalized into land values.

The provisions allowing capital gains treatment for royalties from coal and domestic iron ore production are exceptions to the general rule that royalties are ordinary income taxable at regular rates. Without special treatment owners of coal and iron ore properties might sell their land to get capital gains rates. Repeal of these provisions would end special subsidies available for these two minerals and would equalize treatment between owners who develop their own properties and those who sell the rights.

REV-15 ELIMINATE PREFERENCES FOR FINANCIAL INSTITUTIONS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities	0.4	1.3	2.3	3.2	4.0	11.2
Repeal the Deduction for Excess Bad-Debt Reserves	0.9	1.0	1.0	1.1	1.2	5.2
Treat Credit Unions Like Other Thrift Institutions	0.1	0.2	0.2	0.3	0.3	1.1
Repeal the 20 Percent Deduction for Taxable Income from Life Insurance Activities	0.7	1.0	1.0	1.1	1.2	5.0
Repeal the Small Life-Insurance Company Deduction	0.1	0.1	0.1	0.1	0.1	0.5

Banks, thrift institutions, and life insurance companies receive certain tax preferences that are not allowed other businesses. Additional revenues could be raised by eliminating or reducing such preferences. All of these possible changes would tend to place different financial institutions on a more equal footing, and to result in tax treatment more closely resembling that of other businesses. They might also have negative effects, since each special provision was originally enacted to encourage a particular activity that might be discouraged by repeal.

Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities. Individuals and businesses are generally allowed to deduct from their taxable income interest charges paid on debt incurred in producing taxable, but not tax-exempt, business income. In an exception to this general treatment, banks are allowed to deduct interest payments made to depositors and other lenders even when their funds are used to finance the purchase of tax-exempt securities. This special exception was restricted to 85 percent of the previously allowed deduction in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and to 80 percent in the Deficit Reduction Act of 1984 (DEFRA). Even with this restriction, banks have a unique tax benefit--a tax deduction equal to 80 percent of the interest cost of financing tax-exempt securities. Elimination of the interest deduction for bank holdings of tax-exempt securities would increase federal tax revenues by $11.2 billion during the 1986-1990 period. One consequence of further limiting this deduction is that tax-exempt securities would become less attractive to commercial banks. This would narrow the market for such securities and therefore could raise borrowing costs to states and localities.

Repeal the Deduction for Excess Bad-Debt Reserves. Most businesses are allowed to deduct reserves for bad debts only to a "reasonable" extent determined by their actual experience. In an exception to this general rule, banks and thrift institutions are allowed a tax deduction for bad-debt reserves in excess of the amount they actually experience. These deductions are permanent, with no provision for recapture if repayment experience proves more favorable. Under current law, banks will be allowed a deduction for bad debt reserves only until the end of 1987. The deduction is currently limited to 0.6 percent of total loans. For thrift institutions--savings and loan associations and mutual savings banks--the deduction may be as high as 40 percent of their taxable income if they make a specific proportion of their loans (82 percent for savings and loans, 72 percent for mutuals) for real estate, and if they meet other conditions. These deductions were reduced to 85 percent of the amount of the bad-debt reserve in excess of actual experience by TEFRA, and to 80 percent by DEFRA.

If all financial institutions were prohibited from taking excess deductions after July 1, 1985, revenue gains would amount to $5.2 billion from 1986 through 1990. Without the excess bad-debt reserves deduction, thrift institutions might be less willing to invest in relatively risky mortgages; however, at present the amount of excess reserve allowed is not related to the riskiness of an institution's loans.

Treat Credit Unions Like Other Thrift Institutions. Before 1951, savings and loan institutions, mutual savings banks, and credit unions were not subject to federal income taxes, because they were regarded as operating for the sole benefit of their members. Since 1951, only credit unions have remained tax-exempt. However, financial deregulation has blurred the distinction between credit unions and other financial institutions. Taxing credit unions in the same manner as other financial institutions would raise $1.1 billion in revenue over five years.

Repeal or Scale Back Special Deductions for Life Insurance Companies. The taxation of life insurance companies has undergone a major restructuring that started in TEFRA and was completed in DEFRA. As part of this restructuring, a compromise about the level of taxes that the life insurance industry should be expected to pay was reached. The result was a provision of DEFRA allowing all life insurance companies to deduct 20 percent of their otherwise taxable income from life insurance products. Small life insurance companies (generally those with assets of less than $500 million) are allowed a special small-company deduction of 60 percent of the first $3 million, which is reduced to zero as income increases from $3 million to $15 million. The base for computing the 20 percent general deduction is reduced by the amount of the small-company deduction used.

A reduction in one or both of the special life insurance provisions would increase revenues from the life insurance industry without requiring a major change in the new structure of the tax treatment of the industry. The revenue gain from repealing both provisions would be $0.7 billion in 1986 and $5.6 billion between 1986 and 1990. An additional argument for repealing or scaling back the small life insurance company deduction is that stability and financial security are such basic requirements of the life insurance business that it may not be in the public interest to encourage small companies. On the other hand, the revision of life insurance company taxation required a major effort by the Congress. For this reason, it might well be best to leave the new rules unchanged for a time.

REV-16 RESTRICT USE OF THE CASH METHOD OF ACCOUNTING

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	0.4	0.8	0.8	0.8	0.8	3.5

With the cash method of accounting, a receipt is included in income when it is actually received, and expenses are deducted when they are actually paid, except for depreciation deductions. The cash method is not permissible for most accounting purposes because it does not reflect changes in accounts receivable and payable or in the size of inventories, which determine economic income in any given period. Under the generally used accrual method of accounting, a receipt is included in income when all the events that determine the right to receive it have occurred, and an expense is deducted when all the events that determine the liability and its amount have occurred.

Under present law, most service industries and farms may use the cash method for tax purposes. The use of the cash method of accounting by some taxpayers, while others employ the more common accrual basis, can lead to a mismatching of income and deductions when the cash method taxpayer provides a service (or farm product) to an accrual method taxpayer. The mismatching occurs because the accrual method taxpayer deducts the liability when it has been established, while the cash method taxpayer is able to defer reporting the income from the same transaction until the cash payment has been received. The effect of this is to reduce federal revenues.

The cash method of accounting for tax purposes could be restricted to businesses that averaged less than $5 million annual gross receipts over the three most recent years, and that do not regularly use any other accounting method. If this restriction was phased in gradually over the next six years, $3.5 billion would be added to federal revenues between 1986 and 1990.

Because cash method accounting for tax purposes is relatively simple, many argue that it is justified for small businesses, which may find the accrual method complicated. Under current law, however, cash method accounting for tax purposes is also available to banks and other businesses that already use the accrual method for financial accounting purposes, and to large service organizations that would not be unduly burdened by an accrual accounting requirement, such as accounting, law, and advertising firms.

REV-17 TAX LIMITED PARTNERSHIPS WITH MORE THAN 35 LIMITED PARTNERS AS CORPORATIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	0.3	0.7	0.5	0.4	0.3	2.1

A corporation's income is not taxable to its shareholders until it is distributed to them, and its losses, deductions, and tax credits can be used only against its own income and tax liability. In contrast, income from a partnership is not subject to a separate tax; it flows through to its partners, who report their shares of its income, losses, deductions, and credits on their own income tax returns. If limited partnerships with more than 35 limited partners were taxed as corporations (beginning January 1, 1986, for new partnerships, and January 1, 1990, for partnerships organized before the date of introduction), it would add $2.1 billion to federal revenues between 1986 and 1990.

Under current law, a large limited partnership can have most of the economic and legal attributes of a corporation, but it is able to avoid the corporate tax and pass its income and losses through to limited partners whose relationship to the organization is not significantly different from that of corporate shareholders. As a result, limited partnerships have become a common means of raising capital for investments in tax-favored activities, such as real estate and oil and gas drilling. Investors in these activities can use the tax credits and deductions of the limited partnerships to reduce or defer taxes due on other income. The tax shelter activity made possible by the limited partnership form has resulted in a significant erosion of the corporate tax base, as investment capital has shifted from the corporate sector to the partnership sector.

The passthrough tax treatment of limited partnerships also seriously complicates the audit and administrative responsibilities of the Internal Revenue Service, because any adjustment to the income or loss of a partnership results in adjustments to the taxes of each of the partners, sometimes many years after the original returns were filed.

If limited partnerships with more than 35 limited partners were taxed as corporations, the treatment of similar types of business organizations would be more consistent, but only a relatively small number of partnerships would be affected. In 1982, out of more than 1.5 million partnerships, less than 15,000 were limited partnerships with more than 35 limited partners. Two-thirds of the partnerships that would have been affected by the proposal were in real estate or mining and drilling.

Against the proposal it can be argued that current investors in large limited partnerships would suffer losses in the value of their investments. It can also be argued that the double taxation of corporate income, and the inability of corporations with economic losses to pass these losses through to shareholders, are such serious causes of economic distortion that the limited partnership form of investment should not be discouraged.

REV-18 EXTEND THE AT-RISK LIMITATION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	0.3	0.7	0.6	0.5	0.3	2.4

The tax code generally allows an individual taxpayer who invests in depreciable and depletable assets to deduct an amount no greater than the money or property the investor has contributed to the activity plus interest on borrowed funds for which the taxpayer is personally liable. This "at-risk" limitation, which also applies to certain closely held corporations, is intended to prevent investors from taking tax deductions in excess of their possible economic losses. Real estate and certain equipment leasing activities of closely held corporations are exempt. Extension of the at-risk rules to these activities, effective for property acquired after January 1, 1986, would add $2.4 billion to federal revenues between 1986 and 1990.

The current law exceptions increase the potential return to investors in real estate and equipment-leasing tax shelters. The resulting distortions in investment decisions divert capital from more productive uses and undermine respect for the tax system. An argument against extension is that the value of the exclusion from the at-risk rules is capitalized in the price of exempted property, so current investors in real estate and some equipment leasing would suffer windfall losses if this proposal was enacted.

REV-19 REPEAL THE TAX CREDIT FOR EMPLOYEE STOCK OWNERSHIP PLANS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	1.1	2.1	1.4	0.5	0.3	5.4

Employee Stock Ownership Plans (ESOPs) are employee benefit plans to which the employer contributes the firm's stock or cash to purchase its stock. The stock is held in a tax-exempt trust and is not taxed to the employee until distributed to him or her. An employer whose ESOP meets certain requirements can claim a credit for the full contribution, up to one-half percent of covered wages. The ESOP tax credit was first enacted in 1975 for a two-year trial; it has since been extended and modified several times and is now due to expire in 1988. Repealing the tax credit in January 1986 and making ESOP contributions deductible like most other compensation would increase revenues by $5.4 billion over the 1986-1990 period.

The purpose of the tax credit is to encourage corporations to set up and contribute to ESOPs. ESOPs with large stock holdings could broaden the ownership of corporate wealth, supplement retirement income, and strengthen political support for private enterprise. In addition, because ESOPs give employees an ownership interest in their firms, it is argued that ESOPs may improve employee motivation and raise productivity. (It is also argued that if employee stock ownership improves productivity, employers are likely to encourage it without a tax incentive.)

One objection to the tax credit is on grounds of equity. Through the tax credit, the government in effect buys stock and gives it to trusts for particular individuals. The stock gifts are unavailable to others, such as the self-employed and employees of unincorporated or nonprofit businesses. Another objection is that the credit could encourage employees to place too large a share of their wealth in the company's stock, thereby exposing them to large financial losses if the company's stock performs poorly. In contrast, other benefits, such as pensions, provide less risky means of accumulating savings for retirement.

REV-20 TAX THE ACCRUED INTEREST ON LIFE INSURANCE RESERVES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	1.3	3.9	4.1	4.3	4.5	18.1

Premiums paid for whole life insurance policies can be divided into the price of death protection and a savings component. The savings component builds up as a reserve that earns interest year by year. Taxes on this interest are deferred until the policy matures and the policyholder receives it. About 38 million taxpayers save through their insurance policies. By taxing interest accruing after 1985, revenues of $18.1 billion could be raised over the 1986-1990 period. This revenue gain is smaller than that estimated last year, partly because a provision in the Deficit Reduction Act of 1984 will effectively prevent a nontaxable buildup of accrued interest greater than that provided by traditional whole life insurance.

Repeal of the tax deferral would place saving through life insurance on a basis similar to saving through banks, mutual funds, and other channels. It would in effect make the treatment of interest accruing on life insurance reserves similar to the current law treatment of savings accounts, where the accrued interest is taxed as realized income.

An argument in favor of the repeal is that taxing all savings in the same way avoids distortion in the allocation of savings among investments and thereby increases economic efficiency and growth. Because the decision to save through an insurance policy instead of a bank account, mutual fund, or other liquid asset is voluntary, taxpayers can shift some savings to more liquid forms if other income is inadequate to meet accrued tax liabilities.

On the other hand, the fact that deferral protects savers from having to pay taxes on income before it is received is viewed by many as a matter of fairness, because some might have difficulty in making the extra tax payment before receiving the investment income. The deferral also stimulates saving, in particular saving through life insurance policies. This stimulus is similar to that accorded pension fund saving, though slightly less generous.

The yearly revenue gains shown above represent taxes on interest accruing that year. Interest accumulated before the tax change would continue untaxed until received by the policyholder.

REV-21 REPEAL THE DIVIDEND EXCLUSION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	0.2	0.6	0.6	0.6	0.6	2.6

Under current law, taxpayers may exclude from their adjusted gross income up to $100 ($200 for joint returns) of qualified dividends from corporate share ownership. The exclusion is intended to encourage saving, to offset in part the double tax on corporate dividends, and to promote widespread participation in the ownership of corporate equities.

Eliminating this exclusion would increase revenues by $2.6 billion between 1986 and 1990. It would also equalize the taxation of different forms of income and remove a tax benefit that mostly helps upper-income taxpayers who account for the vast bulk of corporate share ownership. In addition, the dividend exclusion is not an effective incentive to save. Because over 96 percent of dividends are received by taxpayers with dividends above the limit, the dividend exclusion provides little incentive for adding to savings or corporate share ownership.

Arguments against eliminating the exclusion are that it provides some offset against double taxation of corporate dividends and that, because of the limit on it, the exclusion provides a proportionately greater reduction in dividend taxes for small investors.

REV-22 REDUCE THE EXCLUSION FOR LONG-TERM CAPITAL GAINS TO 50 PERCENT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline a/	b/	3.1	3.3	3.6	3.8	13.8

a. The net revenue gain may be less if taxpayers respond to higher tax rates by holding assets instead of selling them, and, in the short run, may even be negative.

b. Less than $50 million.

Under current law, 60 percent of the net capital gains for a year (net long-term gains in excess of net short-term losses) is excluded from a taxpayer's adjusted gross income. The effect of this provision is to make the maximum tax rate on net capital gains of individuals equal to 20 percent (the maximum 50 percent tax rate applied to the 40 percent of gains that are included). If the capital gains exclusion was reduced to 50 percent, the maximum marginal tax rate on net capital gains would increase to 25 percent, or half the maximum rate applied to other forms of income.

Prior to 1978, the capital gains exclusion rate was 50 percent. As a result of other provisions of the tax law then existing, and since repealed, combined with a top marginal rate on individuals of 70 percent, it was possible for a taxpayer to confront a tax rate as high as 49.1 percent on an additional dollar of long-term capital gains. Moreover, because of the high rates of inflation prevailing at the time, and the fact that taxable capital gains are not adjusted for price-level changes, real effective tax rates on capital gains were over 100 percent for many transactions. In the past few years, however, the rate of inflation has declined dramatically. The combined effect of the decline in inflation and changes in the tax law has been to reduce the real effective tax rate on capital gains income below tax rates applied to other forms of income.

A reduction in the capital gains exclusion rate to its historic level of 50 percent would reduce differences in tax rates among different forms of capital income. It would also reduce the attractiveness of tax shelters that include as one benefit the conversion of current ordinary deductions to future capital gains. In addition, such a change might be perceived as equitable because capital gains are highly concentrated in the top portion of the income distribution. On the other hand, any reduction in the capital gains preference would reduce overall incentives for saving and capital formation. Further, it would have an adverse impact on some sectors of the economy where the return to capital is typically in the form of appreciation rather than cash returns, in particular the "venture capital" sector.

REV-23 TAX CAPITAL GAINS AT DEATH

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Tax Gains at Death	a/	4.5	4.7	4.9	5.2	19.3
Carryover Basis	a/	0.2	0.5	0.8	1.2	2.7

a. Less than $50 million.

Under current law, a person who receives a capital asset by inheritance takes as the asset's basis its value on the decedent's day of death. Any unrealized capital gain or loss on the asset that had accrued during the decedent's lifetime is not subject to tax. If capital gains were taxed at death (as if the asset were sold), estimated revenue gains would be $19.3 billion between 1986 and 1990.

Taxation of capital gains at death would reduce opportunities for wealthy families to avoid tax permanently on an important source of their income. In addition, it would reduce the bias in current law that favors investments in assets that appreciate in value over investments in assets that pay regular cash returns. An advantage for appreciating assets would continue, however, both because of the continued exclusion from tax of a fraction of long-term capital gains and because of the continued deferral of tax on accrued capital gains income until death. Another benefit of taxation of gains at death is that it would reduce the "lock-in" effect of the current capital gains tax; taxpayers could not avoid capital gains taxes permanently by holding onto appreciated assets rather than selling them. Finally, the recent lowering of estate taxes has made it more important to ensure that income accumulated within an individual's lifetime not escape tax when assets are transferred at death.

The major arguments against taxing gains at death are that it would reduce the incentive to save by raising the expected value of future capital gains taxes, and that in some cases, such as small farms or businesses, it could force an estate to liquidate assets in order to pay the tax. The forced sale problem could be relieved by allowing generous averaging provisions and deferral of tax payments.

As an alternative to taxing gains at death, the heir could be made to take the decedent's basis (carryover basis). This would avoid the liquidity problem mentioned above. Critics have argued that carryover basis would create serious recordkeeping problems because heirs would need to know the prices paid by the decedent for assets purchased many years before to compute their tax liability when they came to sell them.

In the Tax Reform Act of 1976, the Congress enacted carryover basis for assets transferred at death, but this provision never took effect and was repealed in 1980. Any effort either to tax gains at death or to reinstate carryover basis would be a reversal of recent policy trends.

REV-24 REPEAL THE CAPITAL GAINS EXCLUSION FOR HOME SALES BY PERSONS AGED 55 AND OVER

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	0.1	0.8	0.9	1.0	1.1	3.9

Sellers of homes are allowed to defer tax on any capital gain from a sale as long as another home is purchased that is at least as expensive as the one sold. Otherwise, the capital gain from the home plus any gain accumulated from previous homes is subject to tax. If the seller is age 55 or older, however, up to $125,000 of the gain can be excluded from taxation. This exclusion is only available at one time during the taxpayer's life. Repeal of the exclusion would raise $3.9 billion between 1986 and 1990.

Repeal would reduce the bias in the tax code that greatly favors investment in a home over other investments. The cost of this tax bias toward owner-occupied housing, in addition to lost revenues, is slower growth and lower incomes. In addition, the exclusion increases the market price of homes by adding to the tax advantages of homeownership, thereby raising housing costs for people in low tax brackets.

Repeal of the exclusion can also be justified on equity grounds. Capital gains on a home represent an ability to pay just as other income does, and therefore should be subject to income taxation. Even without the exclusion, homeowners would be eligible for the 60 percent exclusion available for other long-term capital gains (which roughly adjusts for inflationary gains). Furthermore, the one-time exclusion does not assist the poor; it mainly benefits elderly homeowners, who today are as well off as the rest of the population.

On the other hand, the exclusion was enacted to reduce the tax barrier that might prevent a person from moving to another home. People of retirement age frequently need smaller homes and may even prefer to rent. Selling their homes, however, would force many to report large capital gains built up over their working years. Without the exclusion, people might stay in their homes until death to escape the capital gains tax. (At death, the basis of the home is raised to its current value, and tax on the decedent's gain is never paid.) It is estimated that the exclusion has modestly increased the number of older persons moving, thereby slightly increasing the supply of housing to growing families. A small number of homeowners, however, are selling and then leasing back their homes, thereby securing the tax advantages of the exclusion without moving to smaller dwellings.

REV-25 DECREASE MAXIMUM LIMITS ON PENSION CONTRIBUTIONS AND PENSION BENEFITS BY ONE-THIRD

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Decrease Limits by One-Third	0.6	1.7	1.9	2.2	2.4	8.9

Currently, private employers cannot contribute annually more than $30,000 per employee to qualified defined contribution pension plans. Nor can they fund defined benefit plans that will result in annual benefits above $90,000 per employee. (Defined benefit plans specify the pension to be received, usually as a percentage of salary, while defined contribution plans specify the annual contribution, usually as a percent of salary.) The limits are scheduled to be indexed for inflation starting in 1988. Cutting each limit by a third, to a $20,000 maximum defined contribution or a $60,000 maximum defined benefit, would raise $8.9 billion over the 1986-1990 period.

Private pensions of $60,000 per year and pension contributions of $20,000 per year are more than adequate to meet average retirement needs. Furthermore, Social Security benefits are almost always received along with private pensions. Maximum Social Security benefits for a couple in 1984 were over $12,000. Individual Retirement Accounts (IRAs) are also available for supplementing employer pensions. Those persons most likely to be affected by a reduction in pension limits are the most likely to use IRAs. Three out of five taxpayers with incomes over $50,000 contribute to IRAs, compared to one out of five of all taxpayers. Thus, the present limits allow very-high-income people to defer and shelter income beyond amounts many would regard as necessary to provide a reasonable amount of retirement security.

An argument against lowering the contribution limits is that the lower limits may reduce private saving. In addition, since pension limits were already lowered by a third in the Tax Equity and Fiscal Responsibility Act of 1982, there may be strong objections to further changes at this time.

REV-26 REPEAL THREE-YEAR BASIS RECOVERY RULE FOR CONTRIBUTORY RETIREMENT PLANS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Repeal Three-Year Rule and Change Exclusion Rates	0.7	2.1	2.7	2.7	2.7	10.8

Payments received from tax-favored employer retirement plans have three components: employee's contributions before retirement, employer's contributions, and investment income accruing under the plan. When a retiree receives a payment, the component drawn from his or her own contributions (called the basis) is nontaxable because those contributions were made from after-tax income. The other portions are taxable. In deciding how much of each year's payments should be included in taxable income, the general rule is that the total of each year's payments is allocated pro rata, with the tax-exempt share equal to the ratio of the employee's basis to the total value of the plan (the present value of the payments based on the life expectancy of the annuitant) at the time payments begin. This general rule is not followed if three years' worth of payments would equal or exceed the employee's basis. In that case, no tax is due on payments until they exceed the employee's basis, after which they are fully taxable.

The three-year rule makes it more likely that annuitants will recover their contributions (or basis) before death. Further, accelerated recovery of employee contributions places most participants in contributory plans on a more equal footing with participants in noncontributory plans, in which employees benefit from a full tax deferral of (employer-paid) contributions until payments begin.

The current recovery rules have been criticized as inequitable. First, the three-year rule is arbitrary, especially with respect to participants who fall just beyond the cutoff date. Second, regardless of which rule is applied, if distributions stop before annuitants have recovered their entire basis tax free, there is no carryover deduction to their estate. The Treasury Department has recommended that the three-year rule be repealed, that standardized recovery periods be used, and that a carryover deduction be enacted for any unrecovered basis. Repealing the three-year rule would add $10.8 billion to revenues in 1986-1990.

This proposed shift to standard recovery periods would eliminate the acceleration of recovery that the current three-year rule causes, thus increasing revenues to the Treasury in the immediate term. On the other hand, a shift in current rules might harm contributory plan participants who are close to retirement and who may have taken the three-year rule into account in their planning.

REV-27 TAX NON-RETIREMENT FRINGE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Tax Health Insurance Premiums						
Income tax	17.0	26.2	29.9	34.1	38.9	146.1
Payroll tax	6.6	10.1	11.9	13.7	15.6	57.9
Tax Life Insurance Premiums						
Income tax	1.6	2.4	2.6	2.8	3.0	12.4
Payroll tax	0.6	0.7	0.8	0.9	0.9	4.0
Disallow "Cafeteria" Plans						
Income tax	0.2	0.7	1.6	2.7	3.2	8.5

Most employer-paid, non-retirement fringe benefits are excluded from the income and Social Security tax bases even though they constitute compensation to employees. This exclusion results in substantial revenue losses. For employer-paid health and life insurance premiums alone, the revenue loss will be $25.6 billion in income tax revenues and $9.7 billion in payroll tax revenues in 1986. Moreover, as employees seek to increase the percentage of total compensation that is received tax free, the revenue loss from this exclusion is growing. This erosion of the tax base will mean that tax rates on remaining income must be increased to raise the same revenues.

Strong equity arguments exist for taxing fringe benefits. At present, a taxpayer receiving no fringe benefits pays the same tax as another with an equal salary but generous fringe benefits. In addition, the benefits of the exclusion are greater for those with higher incomes. This is true for two reasons: these taxpayers receive more fringe benefits and they face higher marginal tax rates, making the exclusion worth more to them.

Arguments against the exclusion can also be made on the basis of efficiency. Employees may bargain for tax-free benefits that they would not be willing to pay for out of after-tax income, thereby leading to overconsumption of the tax-free services.

In contrast, an equity argument can be made for reducing the exclusion, rather than eliminating it altogether. A taxpayer with an all-cash income may have a greater ability to pay taxes than one with the same total income receiving a large percentage of income as employer-paid benefits, since the employer-paid benefits may not be worth as much to him or her as an equal dollar amount of cash wages. On the other hand, if the exclusion was eliminated, employees might insist on receiving cash instead of benefits.

The exclusion of some fringe benefits is scheduled to expire on December 31, 1985. These benefits are legal service plans, transportation (van pools), and educational assistance. Other tax-free benefits include employer-paid dependent care, which represents revenue losses of under $200 million per year through 1990, and miscellaneous benefits such as employee discounts, meals provided on premises for the convenience of the employer, benefits provided at no additional cost to the employer, *de minimus* fringe benefits, and on-premises athletic facilities.

Taxing fringe benefits sometimes presents administrative problems. Assessing the value of some benefits can be very difficult; for example, some airlines provide reduced-fare or free trips where the cost to the carrier of servicing one extra passenger is essentially zero. Further, the costs of collecting taxes on small fringe benefits (such as employee discounts) could exceed the revenue collected. Taxing employer-paid insurance premiums, on the other hand, would create only minor administrative problems. The premiums paid to each employee could be reported on the employee's W-2 form, and withholding computed as it is for other taxable income. In contrast, taxing employer-provided medical benefits would be more difficult, particularly when employers provide medical care directly, or reimburse employees for medical costs incurred (under self-insurance plans).

Tax Employer-Paid Health Insurance Premiums. The present exclusion for employer-paid health insurance premiums has been criticized as particularly inequitable. The exclusion is not currently available to the self-employed. Unlike other tax-free fringe benefits, the qualified health insurance plans (except self-insured medical reimbursement plans) are not subject to nondiscrimination rules. Thus, even within a company, upper-income employees may receive larger health insurance benefits. In general, those with high salaries receive more employer-paid health benefits than do those at lower income levels. In addition, overuse of medical insurance may have led to expanded use of health care services and, thus, driven up prices for all taxpayers--not just for recipients of tax-free health insurance coverage.

Taxing employer-paid health benefits would resolve equity problems, reduce incentives for overuse of medical services, and substantially broaden the tax base. Over the period from 1986 to 1990, repeal of this exclusion would add $146.1 billion to income tax revenues, and $57.9 billion to payroll tax revenues. In addition, to the extent this provision lowered prices by reducing demand for medical services, it would also lower the costs of federal health care programs.

An alternative proposal would limit the present exclusion by taxing employer-paid health insurance premiums exceeding $175 per month for family coverage and $70 per month for individual coverage (in 1985 dollars), with these limits indexed to medical care prices in future years. (See ENT-01). In 1985, these limits would have affected about 21 percent of tax filing units. The Congress has already applied the concept of limiting the exclusion to employer-paid life insurance. This proposal would increase income tax revenues by $3.5 billion and payroll tax revenues by $1.4 billion in 1986. Over the 1986-1990 period, the proposal would raise about $35.3 billion and $14.1 billion, respectively. Any "grandfathering" of high-cost health insurance plans to exempt employees currently covered would reduce these amounts. A similar proposal contained in the Administration's 1984 budget was not acted on by the Congress.

Some argue that the payroll tax applied to employer-paid health benefits might be treated differently from other payroll taxes. If health benefits were treated like other compensation, both the payroll tax and resulting future cash wage replacement income (OASDI) benefits would increase. Instead, the portion of payroll tax attributable to health benefits could be used to fund Medicare, the nation's principal health insurance replacement program.

Tax Employer-Paid Life Insurance Premiums. Employer-paid life insurance premiums are currently excluded from taxable income, but the exclusion is limited to the cost of the first $50,000 of insurance. The exclusion is not available to the self-employed, and nondiscrimination rules apply. Repeal of this exclusion would add $1.6 billion to income tax revenues and $0.6 billion to payroll tax revenues in 1986. Over the period 1986-1990, repeal would yield $12.4 billion and $4.0 billion, respectively.

Because life insurance benefits and pension plan benefits are linked in many fringe-benefit packages, a problem may exist with subjecting life insurance benefits to the payroll tax. When a pension plan has large death benefits, there is likely to be less life insurance provided. Because pension plans are not subject to the payroll tax, the amount of payroll tax paid (and future OASDI benefits received) would depend on the extent to which the death benefit burden was placed on the pension plan. On the other hand, those who purchase their own life insurance do so with income that has been subject to the payroll tax.

An alternative to repeal would be to reduce the limit on the exclusion. By reducing the limit from the cost of $50,000 of insurance to the cost of $30,000, about $5 billion in revenue would be raised in 1986-1990.

Disallow "Cafeteria" Plans. One vehicle for providing employer-paid fringe benefits is a so-called cafeteria plan, under which employees may choose between taxable and nontaxable fringe benefits. The Deficit Reduction Act of 1984 restricted the benefits allowable under a cafeteria plan. At present, a cafeteria plan may allow a choice of cash, employer-paid group term life insurance, disability benefits, accident and health benefits, group legal services benefits, dependent care benefits, and contributions to cash or deferred plans (called 401(k) plans).

The effect of cafeteria plans is to allow some taxpayers to convert taxable cash compensation into tax-free or tax-deferred forms. If the exclusions for nontaxable fringe benefits were repealed, allowed to expire, or limited, the benefits of cafeteria plans would be reduced. Participants in the plans could, however, still elect to convert cash into tax-free health insurance benefits or to defer tax on contributions to 401(k) plans.

Cafeteria plans pose more than an equity problem. The revenue loss from these plans is projected to grow at a rapid rate, from an estimated $0.2 billion in 1986 to $3.2 billion by 1990. Repeal of cafeteria plan provisions would yield $8.5 billion from 1986 to 1990.

On the other hand, cafeteria plans may promote economic efficiencies since employees are not forced to consume services they would not purchase if compensated in cash, particularly health care services. This improvement in efficiency is achieved at the cost of removing more compensation from the tax base.

REV-28 RESTRICT DEDUCTIONS FOR BUSINESS ENTERTAINMENT AND MEALS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Restrict Deductions for Business Entertainment and Meals	0.6	1.4	1.7	1.8	1.9	7.5

In general, the tax code allows deductions for expenses necessary to earn income, including expenses for business entertainment and meals. Unlike many other business-related expenses, it is very difficult to distinguish between meal and entertainment expenses required for business purposes and those that give rise to personal consumption and should therefore not reduce tax liabilities. For example, theater and football tickets, country club dues, and parties or meals at expensive restaurants may all be deductible as business expenses under current law. Restricting these deductions would add $7.5 billion to revenues in 1986-1990.

Elimination of the deduction for business entertainment has been proposed on grounds of equity and efficiency. Some argue that it is not equitable to permit a few taxpayers to deduct expenses for items such as football tickets while most people must pay for them with after-tax dollars. Others argue that the deduction encourages more spending on entertainment than would occur if these activities were not subsidized by the tax system, and that this may have increased the prices of some forms of entertainment for taxpayers who cannot deduct the expenses.

The deduction for business meals could also be reduced without taxing expenses necessary to conduct business. One proposal would limit deductible expenses for entertainment meals (including gratuity and tax) to $10 per person for breakfast, $15 for lunches, and $25 for dinners. In addition, it would limit deductions for meals while traveling to 200 percent of the federal government per diem allowance. These limits would compensate taxpayers for a portion of business meals, but would end the subsidy to taxpayers who deduct unnecessarily expensive meals.

Eliminating or limiting the deductions could have some negative effects on the entertainment and restaurant industries because a large fraction of tickets to sporting and theater events is purchased by businesses. For example, about one-third of all baseball tickets and one-half of all hockey tickets are purchased by business firms. The limitations on business meals would probably reduce the number of meals served at expensive restaurants, but most restaurants would not be significantly affected. One difficulty with specific limits is that they do not have the same value to all taxpayers across the country. Restaurant prices, for example, are generally higher in large urban areas than in smaller cities.

REV-29 ELIMINATE OR REDUCE ITEMIZED DEDUCTIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Allow Medical Expense Deduction Only for Costs Over 10 Percent of AGI	0.4	2.5	2.8	3.1	3.5	12.3
Eliminate Deductibility of State and Local Taxes						
Income taxes	2.9	19.8	22.3	25.3	28.5	98.8
Sales taxes	0.7	4.6	5.3	6.0	6.8	23.4
Property taxes	1.6	11.0	12.2	13.8	15.4	54.0
Limit Itemized Interest Deduction to $10,000 for Joint Returns ($7,500 for Others)	0.6	3.8	4.4	5.1	6.0	19.9
Repeal Charitable Deduction for Nonitemizers	0.4	2.8	0.0	0.0	0.0	3.2
Limit Itemized Charitable Deduction to Contributions Over 2 Percent of AGI	0.8	5.5	5.9	6.4	6.8	25.4

Under present law, taxpayers are allowed a number of itemized deductions, including those for medical expenses in excess of 5 percent of adjusted gross income (AGI), state and local taxes, charitable contributions, and interest payments. These deductions disproportionately benefit those with higher incomes, who have larger amounts to deduct, and who deduct these amounts against higher marginal tax rates. On the other hand, the deductions are intended to protect taxpayers from unusual medical expenses or to provide incentives for taxpayers to engage in desirable activities (for example, homeownership and charitable contributions).

Limit Medical Deductions. The rationale for allowing a deduction for medical expenses is that a taxpayer facing unusually high medical expenses is less able to pay taxes than another with the same income and no medical expenses. Present law restricts this deduction to medical expenses greater than 5 percent of adjusted gross income (AGI).

The medical deduction could be reduced by further limiting deductible expenses to those over 10 percent of AGI. This would continue to insure all taxpayers against unusually burdensome medical expenses and would reduce the total deduction by a larger amount for higher-income taxpayers than for those with lower incomes.

Raising the floor on this deduction would result in $12.3 billion in additional revenues between 1986 and 1990.

Eliminate State and Local Tax Deductibility. Current law allows taxpayers to deduct state and local taxes, including sales, income, real estate, and personal property taxes. These deductions are estimated to reduce revenues by $230.5 billion between 1986 and 1990.

Historically, these deductions were allowed in order to avoid taxing income twice. They also provide indirect revenue sharing, because they enable states to impose somewhat higher taxes than if taxpayers faced the full burden of these taxes. In addition, the deductions tend to reduce differences in effective tax rates among states that may influence the location of industry and people.

Nevertheless, the deductions reduce tax liability only for taxpayers who itemize--largely middle- and upper-income taxpayers. Further, the value of the deductions increases with the marginal tax rate so that they are worth more to wealthy itemizers than to those in lower brackets.

Some favor repeal only of the sales tax deduction. This would add about $23.4 billion to federal revenues between 1986 and 1990. The tax code generally allows deductions for relatively large and unpredictable expenses that affect a taxpayer's economic circumstances. Uniform expenses affecting nearly all taxpayers have traditionally been subsumed in the zero bracket amount and in the exemptions of the tax structure. The sales tax deduction, by virtue of the way it is computed (from standardized tax tables with amounts varying only by state, family size, and income) and its scope of coverage (claimed by nearly all itemizers) fails to meet these general criteria.

Advocates of the sales tax deductions argue that the federal government should not influence the states' choice of taxes by permitting only some of them to be deducted. Eliminating this deduction would be more burdensome for states relying heavily on sales taxes, and could cause some states to shift their tax collections from sales taxes to other taxes to preserve deductibility for their residents. Others contend that use of a sales tax should not be discouraged since it is popularly held to be a fair tax.

Limit Interest Deductions. Current law allows taxpayers who itemize to deduct all interest payments on home mortgages, auto loans, credit card balances, and other consumption borrowing. In addition, they can deduct interest on borrowing that is invested--for example, in stocks--but this deduction is limited to $10,000 in excess of investment income. Just over one-third of all taxpayers itemize interest, claiming an average of $3,900 in 1982. Limiting all itemized interest deductions to $10,000 in excess of net investment income on joint returns ($7,500 in excess on other returns) would affect 1.4 percent of taxpayers and raise $19.9 billion in revenue from 1986 through 1990.

Under an income tax concept, interest is properly deductible to businesses and investors as a cost of earning taxable income. This rationale does not, however, carry over to borrowing for homes, cars, and the like where no taxable income is forthcoming. Nonetheless, the mortgage interest deduction has been justified as an incentive to homeownership. A limit on itemized interest deductions of $10,000 over investment income for joint returns and $7,500 for others would leave a substantial incentive for home or other consumer borrowing. At a 13 percent interest rate, taxpayers filing joint returns could deduct all interest on at least $77,000 of borrowing; single filers could deduct all interest on at least $57,000 of borrowing. Decreasing the incentive for further consumer borrowing would free savings for business investment that increases productivity and economic growth. Taxpayers with homes currently priced over $100,000, however, would probably suffer declines in the value of their homes.

A limit of $15,000/$11,250 would reduce the number affected to 0.6 percent of taxpayers and raise $9.8 billion from 1986 through 1990. Limiting only nonmortgage interest deductions would avoid any impact on house values, but would favor homes over cars, education, and other major purchases. Furthermore, homeowners might avoid the limit by using their homes as collateral to finance other purchases.

Those who favor retaining the deduction for non-business interest note that many taxpayers could increase business-related borrowing to obtain cash for non-business purchases, thus effectively receiving deductions for non-business borrowing. Consequently, eliminating deductions for non-business borrowing would only affect taxpayers without sufficient financial wealth against which to collaterize loans for non-business purposes. This would make costs of housing, automobiles, and other consumer durables higher for taxpayers without other sources of wealth.

Limit or Repeal Charitable Deductions. A deduction for charitable contributions is available both to taxpayers who itemize deductions and to those who take the standard deduction. This deduction will reduce income tax revenues by about $16 billion in 1986, and was taken by 73 percent of all taxpayers in 1983.

The deduction for nonitemizers was intended to encourage those who do not itemize to increase their charitable giving. Because many nonprofit organizations provide services that might otherwise be left to government, increasing the funds of these organizations was considered desirable.

The provision for nonitemizers may be inefficient, however, because the revenue loss may be larger than the extra charitable contributions it generates since many deductions probably represent gifts that taxpayers would have made anyway. (Although economists are not agreed on this, the weight of the evidence seems to indicate that new contributions made as a result of the deduction are less than the resulting tax loss.) In addition, because nonitemizers tend to be in relatively low-income classes, any increases in the amounts they give to charity are likely to be quite limited. One final concern is that this special deduction may set a precedent for making more deductions available in addition to the standard deduction, thereby complicating the tax law and forms and further narrowing the tax base.

The provision for nonitemizers is scheduled to expire at the end of 1986. Eliminating this provision at the end of 1985 would raise $3.2 billion in 1986 and 1987.

Far more revenue could be raised by placing limits on the itemized deduction for charitable contributions. For example, limiting this deduction to contributions in excess of 2 percent of adjusted gross income (AGI) would raise about $25.4 billion over the period 1986-1990. (Approximately 71 percent of itemizers claiming the charitable deduction contribute less than 2 percent of AGI.)

As with the deduction for nonitemizers, the itemized deduction was intended to encourage charitable giving. Limiting the deduction to relatively large contributions might improve the cost-effectiveness of the subsidy because most taxpayers would probably make small contributions without the tax incentive. Limiting the deduction for small contributions would also reduce the requirement to document these contributions. A less restrictive alternative would be to set the limit at 1 percent of AGI. This would raise less revenue (about $15.5 billion over 1986 to 1990) but would have a smaller adverse effect on the amount contributed to charity.

Another option, with a smaller revenue gain, is the taxation of gains on property donated to charitable organizations. Current law allows donors to deduct the fair market value of donated property, but does not tax the appreciation on the property. This special treatment favors donors of appreciated property (who receive the deduction plus the tax exemption of capital gains) over donors of cash (who receive only the deduction). The provision may also be abused, because the tax benefit increases when the value of property is overstated. In extreme examples, donors could receive tax benefits that exceed the current value of the property.

Taxing the gains on donated property would remove incentives for overvaluation of property, and would treat donors of property and donors of cash equally. It would raise revenues of about $1 billion in 1986-1990. This change, like the others mentioned, could also lead to reduced charitable contributions.

REV-30 INCREASE TAXATION OF NON-MEANS-TESTED ENTITLEMENT BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Social Security	2.1	7.1	7.8	8.8	9.4	35.2
Railroad Retirement Tier I	0.1	0.2	0.2	0.2	0.2	0.9
Unemployment Compensation	0.3	1.0	0.9	0.9	0.8	3.9
Workers' Compensation	1.5	2.7	2.9	3.2	3.5	13.8

Under current tax law, certain entitlement benefits are included in adjusted gross income while others are completely or partially excluded. Historically, most entitlements were exempted from income taxation on the theory that they were forms of assistance to typically poor recipients. Moreover, because the transfer payments made to beneficiaries were small, the revenue loss from the tax exemptions was negligible. In recent years, however, such transfers have reached more well-to-do households and gradually accounted for much larger fractions of family income. If transfers were to be taxed the same way as other sources of personal income, it would be necessary to include in adjusted gross income all Social Security benefits and Railroad Retirement Tier I benefits in excess of employee contributions, all unemployment insurance benefits, and workers' compensation benefits (the latter are currently totally exempt from taxation).

Other entitlement benefits currently not subject to tax include (1) the value of Medicare Hospital Insurance (HI) coverage in excess of any individual's HI payroll contribution, (2) the subsidy for supplemental medical insurance premiums (SMI) under Medicare, and (3) all means-tested entitlement benefits. A proposal to tax the value of HI coverage in excess of an individual's contributions and to tax the insurance value of SMI benefits is discussed elsewhere (ENT-07). Revenue gains from taxing benefits from means-tested programs such as Aid to Families with Dependent Children would be small, since few people who qualify for means-tested programs would have enough income to incur any federal income tax liability.

Tax Half of All Social Security and Tier I Railroad Retirement Benefits. Under current law, adjusted gross income includes the lesser of one-half of Social Security and Tier I Railroad Retirement benefits or the excess of the taxpayer's combined income (adjusted gross income plus nontaxable interest income plus one-half of benefits) over a threshold amount. The threshold amount is $25,000 for single returns and $32,000 for joint returns.

Social Security benefits can be viewed either as welfare payments, because they provide some minimum level of income, or as pensions because they are based on past earnings. Taxation of benefits on the same basis as private pensions would require taxation of all benefits in excess of contributions. For current beneficiaries, the portion of benefits taxed would be very high since payroll taxes were low until recently. Even for workers who entered the work force as recently as 1979, about 83 percent of benefits would be subject to tax.

Increased taxation of the amount of benefits in excess of employee contributions could be accomplished in a number of ways. One practical proposal is to include all benefits attributable to the employer's share of contributions (50 percent) in taxable income, as has been the case since 1984, but eliminate the income thresholds currently used in determining the tax on Social Security and Tier I benefits. This would add $36.1 billion to revenues in 1986 through 1990.

Including 50 percent of Social Security benefits and Tier I benefits for all beneficiaries in taxable income would have two major advantages. First, it would make the taxation of these benefits more consistent with the taxation of other pension benefits, thereby strengthening the pension or deferred compensation logic of the program. Second, taxing benefits for all would reduce work or saving disincentives now facing beneficiaries near the threshold.

On the other hand, reducing the current after-tax level of Social Security benefits would reduce the standard of living of many of today's elderly people. This would be regarded by many as a violation of a social contract. Moreover, because Social Security constitutes a larger fraction of the retirement income of middle-income elderly and disabled individuals than of upper-income retirees, taxing their benefits at even a relatively low marginal tax rate has a greater effect on their after-tax disposable income than the effect on those higher in the income distribution. If benefit levels were increased to offset this tax policy change, however, the budget deficit would not be reduced.

Tax All Unemployment Insurance Benefits. Under current law, taxpayers must include unemployment insurance compensation in adjusted gross income using a graduated formula if their threshold income exceeds $18,000 for joint filers and $12,000 for single filers. Taxing all unemployment benefits would add $3.9 billion to revenues in 1986 through 1990.

The argument for including all unemployment insurance benefits in income is that doing so would tax these benefits the same way as the wages they replace, make net unemployment insurance benefits received by any individual worker dependent on the total income of the family unit, and reduce the work disincentives that these benefits may create. Opponents argue that the tax burden caused by increased taxation of these benefits would fall most heavily on those least able to afford it.

Tax Workers' Compensation Benefits. Workers' compensation benefits reimburse employees for medical costs and lost income resulting from work-related injuries. These benefits are not taxable under current law. Including these benefits in adjusted gross income would make their tax treatment consistent with that of other forms of income and would reduce work disincentives. Seventy-five percent of benefits cover income loss and the remaining 25 percent cover medical costs. In some cases, the after-tax value of wages for those able to return to work is less than their tax-free benefits. Taxing workers' compensation benefits would add $13.8 billion to revenues in 1986 through 1990.

Opponents argue that damages for nonwork-related injuries are not subject to tax, even though a portion reimburses for income loss, and that taxation of workers' compensation benefits would treat these two types of compensation inconsistently. They also argue that taxation of benefits would not significantly increase the incentive to work.

REV-31 ELIMINATE EXTRA TAX EXEMPTION FOR THE ELDERLY AND THE BLIND

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	1.0	3.0	3.0	3.1	3.2	13.3

Any taxpayer at least 65 years old or blind is permitted to claim an extra $1,000 exemption. The most widely perceived reasons for these provisions are the lower income and extra costs of living (especially medical costs) of the elderly and the blind. Repeal of the extra exemption would increase revenues by about $1 billion in 1986 and by about $13 billion through 1990. Most of the revenue gain (99 percent) would be paid by the elderly.

The extra exemption is criticized on several grounds. First, neither age nor blindness is a particularly accurate indicator of financial need. In 1982, 16 percent of all extra exemptions for age and 13 percent of those for blindness were claimed by taxpayers with adjusted gross incomes of $30,000 or more. The poorest of the elderly and the blind--those whose incomes are so low that they do not file tax returns--do not benefit from the extra exemption at all. In 1982, 14 million exemptions were claimed out of an estimated 26 million elderly persons. Moreover, taxpayers with high incomes face higher marginal tax rates so that the exemption gives them greater relief from tax than those with lower incomes.

Second, any elderly or blind taxpayer with extraordinary medical bills can deduct them from adjusted gross income. The extra exemption is neither needed to offset such expenses nor related to the size of a taxpayer's medical bills.

Third, the extra exemption was adopted when Social Security benefits were low and the incidence of poverty among the elderly was much higher than among the population in general (35.2 percent versus 22.4 percent in 1959). In 1983, largely because of Social Security, only 14.1 percent of the elderly were in poverty (compared with 15.2 percent for all persons). Although some Social Security benefits are now partially taxed, this does not affect taxpayers with modified adjusted gross incomes of less than $32,000 (for joint returns; $25,000 for single returns).

Finally, the current tax law also provides a special credit for the elderly and the handicapped. A nonrefundable 15 percent credit is applied to a specified "initial base amount" ($5,000 for single filers, or married couples of whom only one is 65 or older; $7,500 for married couples both of whom are 65 or older; for the disabled, the lesser of these amounts or disability income) reduced by nontaxable pension and disability benefits, and one-half of adjusted gross income in excess of $10,000.

Proponents of retaining the exemption contend that it should be evaluated in the context of the overall goals of the entitlement system, which include providing benefits to the elderly and handicapped without regard to income criteria.

If the Congress wished to protect needy taxpayers from the higher taxes resulting from repeal of the extra exemption, however, the present credit for the elderly and the disabled could be expanded. In addition to making the blind eligible, the "initial base amounts" could be raised to $6,100 for single filers (and married couples only one of whom is 65 or older) and to $9,500 for joint filers both of whom are 65 or older. This increase in the credit would compensate for elimination of the exemptions for most aged and blind taxpayers with incomes less than $14,200 (for a married couple) while reducing the revenue pickup by less than $0.5 billion in the years from 1986 through 1990.

REV-32 INCREASE AUDIT COVERAGE AND EXPAND WITHHOLDING

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Increase Audit Coverage a/	0.4	1.3	2.3	2.9	3.8	10.8
Extend Coverage of Withholding	1.6	4.1	4.4	4.8	5.0	19.8

a. Net of increased outlays.

Compliance with the tax laws apparently declined significantly during the 1970s. The Internal Revenue Service (IRS) estimates that about $90 billion in taxes owed went unpaid in 1981, a nearly threefold increase over 1973 (or a 58 percent increase after adjusting for inflation). Since 1981, however, marginal tax rates have been lowered by 23 percent, and a number of provisions have been enacted to improve the reporting of income. Thus, although noncompliance remains a severe problem and no current data or estimates are available, it is likely that the gap between taxes owed and taxes paid (the "tax gap") has declined since 1981.

Although illegal activities are responsible for part of the tax gap, 90 percent of the revenue shortfall is thought to represent underreporting of income from legal activities. Income underreporting was estimated to account for 60 percent of the tax gap--about $52 billion in 1981. Overstated expenses, deductions, and credits accounted for $13 billion; failure to file returns for $3 billion; and underpayments for about $7 billion. (Corporations were responsible for only $6 billion--6.9 percent--of the tax gap.)

In both 1982 and 1984, the Congress enacted provisions expected to increase compliance with the tax laws. The provisions outlined below could increase it further, adding $2.0 billion to revenues in 1986 and $30.6 billion over the 1986-1990 period.

Increase Audit Coverage. The number of examiners and data processing capacity at the IRS have not kept pace with either the increased work load or the increasing complexity of the tax code. Audit coverage has fallen from 2.6 percent of all returns in 1976 to an estimated 1.4 percent in 1985. Adding new IRS staff could bring an immediate and large payoff in revenues--estimated to be about $8 for each additional dollar spent. Increasing the percentage of returns examined to 1.5 percent in 1986, rising to 2.3 percent in 1990, would raise about $0.5 billion in 1986 and $12.4 billion over the 1986-1990 period. These additional revenues would be partly offset by about $1.6 billion in 1986-1990 outlays for additional staffing and other resources. Moreover, this increased audit coverage would impose additional compliance burdens on all taxpayers--including honest ones.

Extend Coverage of Withholding. Increasing the coverage of withholding, or raising withholding rates (where they have proved to be too low), could also increase taxpayer compliance. In the Tax Equity and Fiscal Responsibility Act of 1982, the Congress enacted withholding on interest and dividends and optional withholding on pensions, annuities, and lump-sum distributions. Additional enforcement provisions were enacted in the Deficit Reduction Act of 1984. The provision for withholding on interest and dividend income was repealed in 1983, however, and replaced by a less comprehensive system of withholding. In the future, the Congress may want to reconsider the original 1982 withholding provisions. Such a measure would raise $1.0 billion in 1986 and $9.1 billion over the 1986-1990 period. Other sources of income on which withholding could be made mandatory are pensions and other retirement income, independent contractors, and royalty payments for items such as patents, copyrights, and oil and gas rights. Mandatory withholding on these sources of income would raise an additional $0.6 billion in 1986 and $10.7 billion over the 1986-1990 period.

While expanded withholding would increase the efficiency of IRS enforcement and allow revenues to increase without adding to enforcement resources, it would impose additional administrative costs on business. Opponents of withholding also note that the IRS could greatly improve enforcement without withholding by making better use of data already available on information returns. The recent improvements in computerization, including increases in magnetic media reporting, may increase compliance enough to diminish the potential gains from additional withholding. Finally, the Congress overwhelmingly rejected withholding on interest and dividends in 1983.

REV-33 REDUCE TAX PREFERENCES ACROSS THE BOARD

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1986	1987	1988	1989	1990	Cumulative Five-Year Addition
Reduce the Value of Tax Preferences	8	33	40	45	52	178

Significant revenue could be raised by eliminating or reducing tax preferences, which are the deductions, exclusions, and credits that reduce the tax payments of selected persons and businesses. Elimination of tax preferences on an item-by-item basis might be very difficult because groups who would lose tax benefits would strongly oppose such changes. An across-the-board partial reduction in preferences might be politically more feasible since it would not single out specific groups of taxpayers for large tax increases.

One proposal to reduce tax preferences calls for a 10 percent cut in itemized deductions and a 20 percent reduction in most credits, exclusions, and other deductions. It would also lengthen depreciation lives by 20 percent, and would reduce limits that apply to some tax preferences by the same percentage. Such cuts would raise an estimated $178 billion in revenues during the 1986-1990 period.

This approach would in general raise more revenue from those taxpayers currently receiving larger total tax benefits, in contrast to an income tax surtax that would raise the most revenues from those already paying the most in taxes. As a result, it would reduce differences in taxes paid by taxpayers with similar incomes who make different use of tax preferences, and would make after-tax returns to different economic activities more equal. Consequently, a generalized reduction in preferences would probably involve a smaller loss in efficiency than would higher tax rates that raised equal revenues.

A cut in preferences across the board could have negative effects, particularly if it failed to distinguish between tax provisions that subsidize some taxpayers or activities and those that are necessary for proper measurement of income. Cutting across the board might also reduce preferences that arguably promote legitimate public objectives, such as encouraging charitable giving. Finally, equal percentage cuts in preferences might have unequal effects on economic incentives, since, for example, a 10 percent reduction in a credit will have a larger after-tax effect on incentives than a 10 percent cut in a deduction.

REV-34 EXPAND THE EXISTING CORPORATE MINIMUM TAX, OR REPLACE IT WITH AN ALTERNATIVE MINIMUM TAX

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Expand Base of Present Add-On Minimum Tax on Preferences	2.2	4.3	5.7	7.6	11.5	31.3
Impose 15 Percent Alternative Minimum Tax on Comparable Base	3.3	5.5	6.1	6.6	9.7	31.2

Under current law, a corporation that makes extensive use of tax preferences may be subject to an add-on minimum tax equal to 15 percent of the difference between the total of certain tax preferences and the greater of either $10,000 or its regular income tax liability. This add-on minimum corporate tax could be expanded by including more items in the list of preferences subject to the tax, up to the point where the add-on minimum tax base was equal to the difference between economic income and the current regular tax base. The revenue gain would depend on the rate and on the number and size of preferences included. Another option is to replace the present minimum tax on tax preferences with an alternative minimum tax on an expanded income base. Again, the revenue effect would depend on how much the base was expanded, with the greatest revenue gain expected from a minimum tax on economic income.

A very broad expansion of the present add-on minimum tax could add as much as $31.3 billion to revenues over the 1986-1990 period. A revenue pickup of this magnitude requires a base that includes both the difference between ACRS depreciation and straight-line depreciation over useful lives (assumed to be ADR midpoint lives for machinery and equipment and 40 years for structures for the purpose of these estimates) and most of the tax benefits generally considered to be tax expenditures. A 15 percent alternative minimum tax on a base with the same depreciation rules and including all of the same preferences, but with an exclusion of $50,000, would increase revenues by $31.2 billion between 1986 and 1990.

Either an add-on or an alternative minimum tax would be more equitable than a surtax, which would be paid by corporations already subject to high tax rates. In addition, either of these options would tend to equalize effective tax rates among corporations compared with current law. This would be accomplished, however, solely by raising low effective tax rates; those already paying high rates would continue to do so. Moreover, the preferences that currently allow corporations to reduce their liabilities enough to make them subject to these suggested minimum taxes were all enacted to promote activities that might suffer if the tax incentives were reduced. Another argument against minimum taxes is that they greatly complicate the process of tax calculation, and can lead to higher than intended tax rates if carryover items (net operating losses, investment credits, and foreign tax credits) and deferral items (such as accelerated depreciation in excess of straight-line) are not handled very carefully.

REV-35 PLACE A PER COUNTRY LIMIT ON THE FOREIGN TAX CREDIT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
Addition to CBO Baseline	0.9	2.5	3.0	3.3	3.6	13.3

Under present law, U.S. taxpayers are allowed a credit for foreign income taxes paid. The credit is limited to the amount of U.S. tax that would otherwise be owed on the foreign-source income. This limit is intended to prevent use of the foreign tax credit to offset foreign tax rates higher than the U.S. rate. The limitation applies to the overall total of foreign taxes, rather than applying separately to taxes paid on income from each country. As a result, a taxpayer with investments in a country with a tax rate higher than the U.S. rate can reduce its tax by also investing in a foreign country with a low tax rate. The foreign tax credit from the high-tax country can then be used to reduce U.S. taxes on income from the low-tax country.

If the foreign tax credit was computed on a per country basis, taxpayers with excess foreign tax credits from investments in high-tax countries would no longer be able to reduce their total tax burdens by shifting investment from the United States to low-tax countries. This proposal would prevent the foreign tax credit from distorting investment decisions, but it would be difficult to enforce because foreign taxes and income sources would have to be matched explicitly. Foreign subsidiaries operating in more than one country would have strong incentives to shift reported income between high- and low-tax countries in order to circumvent the per country limitation.

A per country limitation on the foreign tax credit would add $13.3 billion to federal revenues between 1986 and 1990.

APPENDIX

SUMMARY TABLE OF SPENDING AND TAXATION OPTIONS BY BUDGET FUNCTION

The preceding pages of this report contain 123 deficit reduction options that are specific to particular federal programs or to provisions of the Internal Revenue Code. The table that follows lists those options by budget function. When an option affects several functions, it is assigned to the function on which it has the largest impact. Some spending options affect all functions, and some taxation options cannot be classified by function at all; options of this kind are carried at the end of the table.

The title for each option is followed by a designation in parentheses--for example, Cancel the MX (DEF-01) or Revise Depreciation Rules (REV-08). The designation permits locating the option in the table of contents at the beginning of this volume, which in turn locates the discussion of the option in the body of the report.

For each option, the table displays the estimated 1986-1990 savings or revenue gains that would result from its enactment. Both budget authority and outlay savings are shown for the spending reduction options. The estimates do not include any secondary effects--that is, effects on spending or revenues that would occur if the performance of the economy as a whole was altered by enacting the options shown here.

Unless specified otherwise, the estimates assume the spending reduction options in the table take effect on October 1, 1985, and the taxation options on January 1, 1986. The separate options cannot be added to a grand total. Some are mutually exclusive; some overlap with others; and in some cases there are interactions, so that if several options were enacted together, the combined savings would differ from the total of those estimated for each option separately.

SUMMARY TABLE. PROJECTED SAVINGS AND REVENUE GAINS, BY BUDGET FUNCTION, FISCAL YEARS 1986-1990 (In millions of dollars)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
050 National Defense						
Cancel the MX (DEF-01)						
Budget Authority	4,100	3,300	2,600	1,600	70	11,670
Outlays	1,170	2,270	2,600	2,380	1,730	10,150
Combine CFM-56 Tanker Re-engining with Cheaper Alternative (DEF-02)						
Budget Authority	-90	20	0	1,000	1,700	2,630
Outlays	-80	-90	-50	100	700	580
Amend the Administration's Airlift Plan (DEF-03)						
Budget Authority	500	900	2,700	2,500	4,000	10,600
Outlays	270	560	1,150	1,920	2,280	6,180
Reduce Construction of New Submarines and LSDs While Extending the Service Life of Existing Ships (DEF-04)						
Budget Authority	1,000	1,000	1,200	1,200	1,300	5,700
Outlays	60	200	400	610	840	2,110

NOTE: Dashes in this table indicate less than $2.5 million.

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
050 National Defense (Continued)						
Reduce the Rate of Procurement of Patriot Missiles (DEF-05)						
Budget Authority	70	150	230	230	230	910
Outlays	10	50	120	180	220	580
Cancel or Reduce Procurement of the F-15 (DEF-06)						
Freeze Annual Procurement at 36						
Budget Authority	300	300	700	800	800	2,900
Outlays	40	180	320	520	660	1,720
Cancel the F-15						
Budget Authority	2,500	2,500	2,900	3,100	2,900	13,900
Outlays	430	1,420	2,070	2,500	2,800	9,220
Cancel the LANTIRN Program (DEF-07)						
Budget Authority	500	900	700	700	700	3,500
Outlays	80	330	600	680	690	2,380

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
050 National Defense (Continued)						
Cancel the Army Helicopter Improvement Program (DEF-08)						
Budget Authority	300	300	400	400	400	1,800
Outlays	30	150	270	360	400	1,210
Limit Production of the M2 Bradley Fighting Vehicle (DEF-09)						
Budget Authority	300	500	500	470	-100	1,670
Outlays	5	150	340	430	450	1,375
Cancel the Division Air Defense Gun (DEF-10)						
Budget Authority	600	700	600	60	30	1,990
Outlays	50	320	520	570	340	1,800
Delay Procurement of Aquila Remotely Piloted Vehicle (DEF-11)						
Budget Authority	150	270	280	250	160	1,110
Outlays	10	70	170	230	240	720

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
050 National Defense (Continued)						
Limit Spending Growth for Supporting Procurement (DEF-12)						
Reduce Real Growth by 50 Percent						
Budget Authority	900	1,100	1,300	1,400	1,500	6,200
Outlays	230	560	890	1,120	1,280	4,080
Limit 1986 Spending to Real 1985 Level						
Budget Authority	1,700	5,900	8,600	10,000	10,800	37,000
Outlays	440	2,070	4,480	6,870	8,670	22,530
Limit Growth in DoD Research and Development (DEF-13)						
Reduce Spending by 8 Percent						
Budget Authority	3,100	3,400	3,900	4,500	5,300	20,200
Outlays	1,600	2,850	3,440	4,000	4,640	16,530
Limit 1986 Spending to Real 1985 Level						
Budget Authority	6,300	6,800	10,600	14,100	20,800	58,600
Outlays	3,230	5,720	8,270	11,600	16,500	45,320

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
050 National Defense (Continued)						
Slow or Limit Growth in the Strategic Defense Initiative (DEF-14)						
Spread Spending over Six Years						
Budget Authority	900	1,200	1,500	1,800	2,200	7,600
Outlays	430	940	1,290	1,620	1,960	6,240
Reinstate Former Spending Level						
Budget Authority	2,000	2,900	3,700	4,700	5,800	19,100
Outlays	960	2,200	3,120	4,070	5,070	15,420
Limit Spending Growth for Military Construction (DEF-15)						
Limit Spending Growth to 6 Percent						
Budget Authority	1,000	1,200	1,500	1,700	2,000	7,400
Outlays	100	500	900	1,200	1,500	4,200
Limit 1986 Spending to Real 1985 Level						
Budget Authority	1,300	2,800	4,000	5,400	6,600	20,100
Outlays	200	900	1,900	3,100	4,300	10,400

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
050 National Defense (Continued)						
Slow Increases in the Tactical Air Force (DEF-16)						
Budget Authority	0	200	500	900	1,300	2,900
Outlays	0	100	340	630	970	2,040
Place Three Carrier Battle Groups in Reserve (DEF-17)						
Budget Authority	0	70	200	300	400	970
Outlays	0	60	180	300	380	920
Limit Operation and Maintenance Spending (DEF-18)						
Reduce Spending by 3 Percent						
Budget Authority	2,500	2,900	3,300	3,500	3,800	16,000
Outlays	2,000	2,800	3,200	3,500	3,700	15,200
Limit Spending to 1985 Levels						
Budget Authority	3,600	12,200	19,600	21,500	23,500	80,400
Outlays	2,900	10,400	17,800	20,800	22,800	74,700

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
050 National Defense (Continued)						
Reduce COLAs for Working-Age Military Retirees (DEF-19)						
Budget Authority	0	4,070	4,510	4,900	5,300	18,780
Outlays	0	-30	280	550	820	1,620
Restore Previous Enlisted-Officer Ratios (DEF-20)						
Budget Authority	90	315	600	815	905	2,735
Outlays	60	220	425	575	640	19,20
Increase Deductibles for Military Hospital Care (DEF-21)						
Budget Authority	65	65	65	65	65	325
Outlays	50	65	65	65	65	310
Impose Outpatient Fees at Military Medical Facilities (DEF-22)						
Budget Authority	95	100	105	110	120	530
Outlays	75	95	105	110	115	500
Eliminate the Annual Military Pay Raise (DEF-23)						
Budget Authority	1,900	2,000	2,100	2,200	2,400	10,600
Outlays	1,300	1,400	1,400	1,500	1,600	7,200

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
050 National Defense (Continued)						
Consolidate or Close Military Bases or Activities (CIV-05)						
Budget Authority	-90	-100	230	290	340	670
Outlays	-90	-120	210	270	320	590
150 International Affairs						
End the Export-Import Bank Direct Loan Program (NDD-01)						
Budget Authority	3,450	3,200	3,250	1,950	2,150	14,000
Outlays	320	1,150	1,690	1,950	2,000	7,110
Reduce Funding for the Economic Support Fund (NDD-02)						
Budget Authority	400	420	430	450	470	2,170
Outlays	230	290	350	390	420	1,680
Eliminate Cargo Preference for Nonmilitary Shipments (NDD-03)						
On-Budget						
Budget Authority	150	160	160	170	170	800
Outlays	150	160	160	170	170	800

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
150 International Affairs (Continued)						
Eliminate Cargo Preference for Nonmilitary Shipments (NDD-03) (Continued)						
Off-Budget						
Budget Authority	50	50	50	40	20	210
Outlays	20	50	50	50	30	200
Repeal Preferences for Foreign Sales Corporations (REV-11)						
Addition to CBO Baseline	600	1,100	1,200	1,200	1,300	5,400
Place a Per Country Limit on the Foreign Tax Credit (REV-35)						
Addition to CBO Baseline	900	2,500	3,000	3,300	3,600	13,300
250 General Sciences, Space and Technology						
Decrease Funding for the Space Shuttle (NDD-04)						
Budget Authority	260	260	260	270	280	1,330
Outlays	200	250	260	270	280	1,260

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
270 Energy						
Reduce Subsidies for the Rural Electrification Administration (NDD-05)						
Net On- and Off-Budget Savings						
Budget Authority	10	120	220	310	340	1,000
Outlays	10	120	220	310	340	1,000
Reschedule Treasury Payments by the Bonneville Power Administration (NDD-06)						
Budget Authority	50	50	40	40	40	220
Outlays	330	300	290	280	270	1,470
Eliminate Commercially Oriented Energy Development (NDD-07)						
Budget Authority	790	790	830	870	910	4,190
Outlays	340	640	800	840	890	3,510
Increase Energy Taxes (REV-06)						
Impose Tax on Domestic and Imported Oil ($5 per barrel)						
Addition to CBO Baseline	14,800	21,600	21,900	22,200	22,500	103,000

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
270 Energy (Continued)						
Increase Energy Taxes (REV-06) (Continued)						
Impose Oil Import Fee ($5 per barrel)						
Addition to CBO Baseline	6,600	9,500	9,100	9,400	9,800	44,400
Impose Excise Tax on Natural Gas ($1 per 1,000 cubic feet)						
Addition to CBO Baseline	9,200	13,200	13,300	13,400	13,400	62,500
Increase Motor Fuel Excise Tax (12 cents per gallon)						
Addition to CBO Baseline	7,400	10,500	10,300	10,200	10,100	48,500
Impose Broad-Based Tax on Domestic Energy Consumption (5 percent of value)						
Addition to CBO Baseline	9,800	14,800	15,900	17,000	18,300	75,800
Repeal Percentage Depletion Allowance and Expensing of Intangible Drilling, Exploration, and Development Costs (REV-12)						
Repeal Percentage Depletion						
Addition to CBO Baseline	1,300	2,200	2,300	2,400	2,600	10,900

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
270 Energy (Continued)						
Repeal Percentage Depletion Allowance and Expensing of Intangible Drilling, Exploration, and Development Costs (REV-12) (Continued)						
Repeal Expensing of Intangible Drilling, Development, and Exploration Costs						
Addition to CBO Baseline	2,900	4,500	4,000	3,600	3,400	18,300
300 Natural Resources and Environment						
Reduce Support for Inland Waterways (NDD-08)						
Budget Authority	360	370	380	400	410	1,920
Outlays	350	360	370	390	410	1,880
Eliminate Federal Maintenance Assistance for Deep Draft Ports (NDD-09)						
Budget Authority	440	460	470	490	510	2,370
Outlays	430	450	460	480	500	2,320
Eliminate Special Capital Gains Treatment for Timber, and for Coal and Iron Ore Royalties (REV-14)						
Timber Income						
Addition to Baseline	400	800	900	1,000	1,000	4,100

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
300 Natural Resources and Environment (Continued)						
Eliminate Special Capital Gains Treatment for Timber, and for Coal and Iron Ore Royalties (REV-14) (Continued)						
Coal and Iron Ore Royalties						
Addition to CBO Baseline	100	100	200	200	200	800
350 Agriculture						
Strengthen Crop Prices with Mandatory Production Controls (AGR-01)						
Budget Authority	820	3,150	4,350	5,850	6,600	20,800
Outlays	820	3,150	4,350	5,850	6,600	20,800
Limit Income Assistance to Large-Scale Crop Farms (AGR-02)						
Budget Authority	0	1,100	1,050	950	900	4,000
Outlays	0	1,100	1,050	950	900	4,000
Reduce the Price-Increasing Features of Major Crop Programs (AGR-03)						
Elimination of Deficiency Payments						
Budget Authority	730	5,900	7,600	7,500	7,200	28,900
Outlays	730	5,900	7,600	7,500	7,200	28,900

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
350 Agriculture (Continued)						
Reduce the Price-Increasing Features of Major Crop Programs (AGR-03) (Continued)						
Phased Elimination of Deficiency Payments						
Budget Authority	730	280	2,900	6,500	7,000	17,400
Outlays	730	280	2,900	6,500	7,000	17,400
Reduce Price Supports in the Dairy Industry (AGR-04)						
Budget Authority	250	490	710	860	680	3,000
Outlays	250	490	710	860	680	3,000
370 Commerce and Housing						
End Direct and Indirect Subsidies to the Postal Service (NDD-10)						
End Direct Subsidies						
Budget Authority	790	830	860	900	930	4,310
Outlays	790	830	860	900	930	4,310
End Indirect Subsidies						
Budget Authority	10	35	60	100	150	355
Outlays	220	400	460	690	670	2,440

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
End Direct and Indirect Subsidies to the Postal Service (NDD-10) (Continued)						
Total						
Budget Authority	800	865	920	1,000	1,080	4,665
Outlays	1,010	1,230	1,320	1,590	1,600	6,750
Eliminate New Lending or Increase Homeowners' Payments Under Rural Housing Loan Program (NDD-11)						
Eliminate New Lending						
Budget Authority	0	0	380	580	800	1,760
Outlays	1,950	2,350	2,550	2,800	3,100	12,750
Increase Homeowners' Payments						
Budget Authority	-25	-45	220	310	390	850
Outlays	70	150	230	310	400	1,160
Repeal the Reduced Rates on the First $100,000 of Corporate Income or Phase Out the Benefits for Taxable Incomes Above $100,000 (REV-04)						
Repeal Lower Rates						
Addition to CBO Baseline	5,100	8,700	9,000	9,300	9,600	41,700

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Repeal the Reduced Rates on the First $100,000 of Corporate Income or Phase Out the Benefits for Taxable Incomes Above $100,000 (REV-04) (Continued)						
Phase Out Above $100,000						
Addition to CBO Baseline	600	1,100	1,100	1,200	1,200	5,200
Phase Out Above $100,000						
Addition to CBO Baseline	600	1,100	1,100	1,200	1,200	5,200
Revise Depreciation Rules (REV-08)						
Revise Depreciation Rules						
Addition to CBO Baseline	600	-100	3,000	10,900	21,200	35,500
Revise Depreciation Rules and Repeal ITC						
Addition to CBO Baseline	15,500	28,400	36,600	50,000	65,500	196,000
Eliminate Investment Tax Credit or Require Full Basis Adjustment (REV-09)						
Eliminate Credit						
Addition to CBO Baseline	14,500	28,000	32,300	36,000	39,400	150,200

SUMMARY TABLE. (Continued)

Budget Function						Cumulative Five-Year
Options	1986	1987	1988	1989	1990	Savings
370 Commerce and Housing (Continued)						
Eliminate Investment Tax Credit or Require Full Basis Adjustment (REV-09) (Continued)						
Require Full Basis Adjustment						
Addition to CBO Baseline	500	1,700	3,200	4,800	6,300	16,400
Eliminate Private-Purpose Tax-Exempt Bonds (REV-13)						
Mortgage Revenue Bonds--Multiple Dwellings						
Addition to CBO Baseline	100	200	400	700	1,000	2,300
Mortgage Revenue Bonds--Single-Family Homes						
Addition to CBO Baseline	100	500	900	900	900	3,300
Industrial Development Bonds--Small Issues						
Addition to CBO Baseline	100	400	600	800	800	2,700
Industrial Development Bonds--Pollution Control						
Addition to CBO Baseline	--	100	300	400	600	1,500

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Eliminate Private-Purpose Tax-Exempt Bonds (REV-13) (Continued)						
Industrial Development Bonds--Other						
Addition to CBO Baseline	--	100	300	400	600	1,500
Student Loan Bonds						
Addition to CBO Baseline	--	100	200	300	400	1,100
Hospital Bonds						
Addition to CBO Baseline	100	400	800	1,300	1,700	4,400
Eliminate Preferences for Financial Institutions (REV-15)						
Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities						
Addition to CBO Baseline	400	1,300	2,300	3,200	4,000	11,200
Repeal the Deduction for Excess Bad-Debt Reserves						
Addition to CBO Baseline	900	1,000	1,000	1,100	1,200	5,200
Treat Credit Unions Like Other Thrift Institutions						
Addition to CBO Baseline	100	200	200	300	300	1,100

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Eliminate Preferences for Financial Institutions (REV-15) (Continued)						
Repeal the 20 Percent Deduction for Taxable Income from Life Insurance Activities						
Addition to CBO Baseline	700	1,000	1,000	1,100	1,200	5,000
Repeal the Small Life Insurance Company Deduction						
Addition to CBO Baseline	100	100	100	100	100	500
Restrict Use of the Cash Method of Accounting (REV-16)						
Addition to CBO Baseline	400	800	800	800	800	3,500
Tax Limited Partnerships With More Than 35 Limited Partners as Corporations (REV-17)						
Addition to CBO Baseline	300	700	500	400	300	2,100
Extend the At-Risk Limitation (REV-18)						
Addition to CBO Baseline	300	700	600	500	300	2,400

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Repeal the Tax Credit for Employee Stock Ownership Plans (REV-19)						
Addition to CBO Baseline	1,100	2,100	1,400	500	300	5,400
Tax the Accrued Interest on Life Insurance Reserves (REV-20)						
Addition to CBO Baseline	1,300	3,900	4,100	4,300	4,500	18,100
Repeal the Dividend Exclusion (REV-21)						
Addition to CBO Baseline	200	600	600	600	600	2,600
Reduce the Exclusion for Long-Term Capital Gains to 50 Percent (REV-22)						
Addition to CBO Baseline	--	3,100	3,300	3,600	3,800	13,800
Tax Capital Gains at Death (REV-23)						
Tax Gains at Death						
Addition to CBO Baseline	--	4,500	4,700	4,900	5,200	19,300
Carryover Basis						
Addition to CBO Baseline	--	200	500	800	1,200	2,700

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
400 Transportation (Continued)						
Repeal the Capital Gains Exclusion for Home Sales by Persons Aged 55 and Over (REV-24)						
Addition to CBO Baseline	100	800	900	1,000	1,100	3,900
400 Transportation						
Reduce and Retarget Amtrak Subsidies (NDD-12)						
Budget Authority	300	320	330	350	360	1,660
Outlays	270	300	330	340	360	1,600
Reduce Federal Mass Transit Aid (NDD-13)						
Budget Authority	1,950	1,990	2,040	2,060	2,030	10,070
Outlays	700	1,090	1,430	1,660	1,910	6,790
Reduce and Refocus Highway Spending (NDD-14)						
Budget Authority	5,910	6,030	6,140	6,260	6,510	30,850
Outlays	990	4,110	5,170	5,640	6,030	21,940
Raise Aviation User Fees to Cover Air Traffic Control Costs (NDD-15)						
Addition to CBO Baseline	360	440	520	610	700	2,630

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
400 Transportation (Continued)						
Reduce NASA's Commercial Aeronautical Research and Development (NDD-16)						
Budget Authority	360	380	400	420	450	2,010
Outlays	160	330	390	410	430	1,720
Establish User Fees for Certain Coast Guard Services (NDD-17)						
Budget Authority	870	940	950	980	1,010	4,750
Outlays	870	940	950	980	1,010	4,750
450 Community and Regional Development						
Eliminate Automatic Community Development Block Grants for Less Needy Jurisdictions (NDD-18)						
Budget Authority	360	370	380	400	420	1,930
Outlays	10	140	330	380	390	1,250
End Funding of the Economic Development Administration and Urban Development Action Grants (NDD-19)						
Eliminate EDA						
Budget Authority	240	250	260	270	280	1,300
Outlays	140	190	220	250	260	1,060

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
450 Community and Regional Development (Continued)						
End Funding of the Economic Development Administration and Urban Development Action Grants (NDD-19) (Continued)						
Eliminate UDAG						
Budget Authority	440	460	470	490	500	2,360
Outlays	20	110	230	340	470	1,170
Reduce Incentives for Building Rehabilitation (REV-10)						
Repeal the Rehabilitation Tax Credits						
Addition to CBO Baseline	100	500	1,200	2,100	2,700	6,600
Limit Credits to Historic Renovations						
Addition to CBO Baseline	100	400	700	1,100	1,400	3,700
500 Education, Training, Employment and Social Services						
Reduce Guaranteed Student Loan Subsidies (ENT-19)						
Raise Students' Interest Rates						
Budget Authority	--	25	125	280	460	890
Outlays	--	15	95	235	415	760

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
500 Education, Training, Employment and Social Services (Continued)						
Reduce Guaranteed Student Loan Subsidies (ENT-19) (Continued)						
Eliminate In-School Interest Subsidies						
Budget Authority	-105	450	790	960	1,020	3,115
Outlays	-55	310	700	915	1,000	2,870
Reduce Lenders' Subsidies						
Budget Authority	20	60	85	100	105	370
Outlays	10	50	80	95	105	340
Reduce and Retarget Aid for Dependent Care (ENT-22)						
Gross Revenue Gain	110	1,050	1,200	1,350	1,500	5,210
Outlays	-55	-525	-600	-675	-750	-2,605
Net Savings	55	525	600	675	750	2,605
Terminate the Elementary and Secondary Education Block Grant (ECIA, Chapter 2) (NDD-20)						
Budget Authority	560	590	620	660	700	3,130
Outlays	40	430	580	620	650	2,320

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
500 Education, Training, Employment and Social Services (Continued)						
Reduce Funding for Impact Aid (NDD-21)						
Budget Authority	140	140	150	160	170	760
Outlays	120	140	150	160	170	740
Increase Pell Grant Targeting (NDD-22)						
Budget Authority	360	380	400	420	450	2,010
Outlays	70	350	380	400	430	1,630
550 Health						
Tax Some Employer-Paid Health Insurance (ENT-01)						
Income Tax						
Addition to CBO Baseline	3,500	5,700	6,900	8,600	10,500	35,300
Payroll Tax						
Addition to CBO Baseline	1,400	2,200	2,800	3,500	4,200	14,100

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
550 Health (Continued)						
Tax Premiums for "Medigap" Policies (ENT-10)						
Addition to CBO Baseline	3,150	4,550	4,950	5,400	5,850	23,950
Limit Payments for Long-Term Care Services Through a Block Grant (ENT-12)						
Budget Authority	850	1,150	1,450	1,750	2,100	7,300
Outlays	850	1,150	1,450	1,750	2,100	7,300
Modify Federal Employees Health Benefits Program (CIV-10)						
Budget Authority	40	100	180	280	390	990
Outlays	40	100	180	280	390	990
Tax Non-Retirement Fringe Benefits (REV-27)						
Tax Health Insurance Premiums--Income Tax						
Addition to CBO Baseline	17,000	26,200	29,900	34,100	38,900	146,100
Tax Health Insurance Premiums--Payroll Tax						
Addition to CBO Baseline	6,600	10,100	11,900	13,700	15,600	57,900

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
550 Health (Continued)						
Tax Non-Retirement Fringe Benefits (REV-27) (Continued)						
Tax Life Insurance Premiums--Income Tax						
Addition to CBO Baseline	1,600	2,400	2,600	2,800	3,000	12,400
Tax Life Insurance Premiums--Payroll Tax						
Addition to CBO Baseline	600	700	800	900	900	4,000
Disallow "Cafeteria" Plans--Income Tax						
Addition to CBO Baseline	200	700	1,600	2,700	3,200	8,500
570 Medical Insurance						
Reduce Hospital Reimbursements Under Medicare (ENT-02)						
Limit Increases in Medicare's Prospective Payment Rates						
Budget Authority	-90	-280	-510	-810	-1,180	-2,870
Outlays	1,500	2,150	2,500	2,850	3,300	12,300
Reduce Medicare's Payments for Indirect Medical Education Costs						
Budget Authority	-20	-55	-110	-170	-260	-615
Outlays	310	430	580	650	720	2,700

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
570 Medical Insurance (Continued)						
Reduce Hospital Reimbursements Under Medicare (ENT-02) (Continued)						
Reduce Medicare's Payments for Direct Medical Education Expenses						
Budget Authority	-15	-40	-70	-100	-150	-375
Outlays	240	270	300	330	370	1,500
Extend Freeze on Physicians' Fees Paid by Medicare for One More Year (ENT-03)						
Budget Authority	540	620	710	770	770	3,410
Outlays	490	560	650	740	740	3,180
Adopt a Fee Schedule for Reimbursing Physicians Under Medicare (ENT-04)						
Budget Authority	540	780	1,000	1,300	1,600	5,220
Outlays	490	650	890	1,200	1,400	4,630
Increase Medicare's Premium for Physicians' Services (ENT-05)						
Budget Authority	1,650	2,550	3,300	4,300	5,400	17,200
Outlays	1,650	2,550	3,300	4,300	5,400	17,200

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
570 Medical Insurance (Continued)						
Use the Tax System to Impose a Supplementary Income-Related Premium for Physicians' Services (ENT-06)						
Addition to CBO Baseline	100	400	500	500	600	2,100
Tax a Portion of Medicare Benefits (ENT-07)						
Addition to CBO Baseline	500	1,800	2,100	2,300	2,600	9,300
Increase Medicare's Deductible for Physician Services (ENT-08)						
Budget Authority	850	1,200	1,400	1,500	1,750	6,700
Outlays	610	1,050	1,250	1,450	1,600	5,960
Increase Cost Sharing for Medicare and Add Catastrophic Protection (ENT-09)						
Budget Authority	690	840	810	610	500	3,450
Outlays	1,710	2,760	3,230	3,740	4,250	15,690
Increase the Hospital Insurance Payroll Tax by Half a Percentage Point (ENT-11)						
Addition to Baseline	13,900	19,000	20,500	22,000	23,600	99,000

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
600 Income Security						
Require a Two-Week Waiting Period for Unemployment Insurance Benefits (ENT-17)						
Budget Authority	--	--	--	--	--	--
Outlays	--	880	890	900	920	3,590
Index the Unemployment Insurance Taxable Wage Base (ENT-18)						
Addition to CBO Baseline	--	400	850	1,300	1,700	4,250
Reduce Subsidy for Nonpoor Children in Child Nutrition Programs (ENT-20)						
Budget Authority	250	270	280	300	320	1,420
Outlays	250	270	280	300	320	1,420
Modify Civil Service Retirement Provisions (CIV-08)						
Budget Authority	--	60	130	180	220	590
Outlays	110	310	530	780	1,000	2,730
Restrict Long-Term Disability Benefits and Eliminate Sick-Leave Credit for Federal Employees (CIV-09)						
Budget Authority	--	--	--	--	--	--
Outlays	35	110	190	270	370	975

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
600 Income Security (Continued)						
Decrease Maximum Limits on Pension Contributions and Pension Benefits by One-Third (REV-25)						
Addition to CBO Baseline	600	1,700	1,900	2,200	2,400	8,900
Repeal Three-Year Basis Recovery Rule for Contributory Retirement Plans (REV-26)						
Addition to CBO Baseline	700	2,100	2,700	2,700	2,700	10,800
Eliminate Extra Tax Exemption for the Elderly and the Blind (REV-31)						
Addition to CBO Baseline	1,000	3,000	3,000	3,100	3,200	13,300
650 Social Security						
Restrict Cost-of-Living Adjustments in Non-Means-Tested Benefit Programs (ENT-13)						
Eliminate COLAs for One Year						
Outlays	6,200	9,000	9,250	9,300	9,200	42,950
Limit COLAs to Two-Thirds of CPI Increase for Five Years						
Outlays	2,150	5,800	9,600	13,300	17,050	47,850

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
650 Social Security (Continued)						
Restrict Cost-of-Living Adjustments in Non-Means-Tested Benefit Programs (ENT-13) (Continued)						
Limit COLAs to CPI Increase Minus 2 Percentage Points for Five Years						
Outlays	3,600	8,700	13,950	19,400	25,100	70,750
Pay Full COLA on Benefits Below a Certain Level and 50 Percent of COLA on Amounts Exceeding That Level						
Outlays	740	1,950	3,250	4,550	5,850	16,350
Eliminate Social Security Benefits for Children of Retirees Aged 62-64 (ENT-14)						
Budget Authority	-5	-15	-35	-70	-120	-245
Outlays	50	190	360	600	670	1,870
Cover All Newly Hired State and Local Government Workers Under Social Security (ENT-15)						
Addition to CBO Baseline	210	770	1,400	2,050	2,650	7,050
Increase Taxation of Non-Means-Tested Entitlement Benefits (REV-30)						
Social Security						
Addition to CBO Baseline	2,100	7,100	7,800	8,800	9,400	35,200

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
650 Social Security (Continued)						
Increase Taxation of Non-Means-Tested Entitlement Benefits (REV-30) (Continued)						
Railroad Retirement Tier I						
Addition to CBO Baseline	100	200	200	200	200	900
Unemployment Compensation						
Addition to CBO Baseline	300	1,000	900	900	800	3,900
Workers' Compensation						
Addition to CBO Baseline	1,500	2,700	2,900	3,200	3,500	13,800
700 Veterans Benefits and Services						
Eliminate Veterans' Compensation Payments for Those With Low-Rated Disabilities (ENT-16)						
Budget Authority	1,400	1,450	1,500	1,550	1,600	7,500
Outlays	1,300	1,450	1,500	1,550	1,600	7,400
Require Cost Sharing for VA Hospital Care (NDD-23)						
Budget Authority	120	280	310	350	390	1,450
Outlays	120	280	310	350	390	1,450

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
700 Veterans Benefits and Services (Continued)						
Limit Eligibility for VA Hospital Care to Service-Disabled and Poor Veterans (NDD-24)						
Budget Authority	490	1,200	1,450	2,000	2,300	7,440
Outlays	490	1,200	1,450	2,000	2,300	7,440
Convert Underused Acute-Care Beds in VA Hospitals (NDD-25)						
Budget Authority	100	180	240	280	290	1,100
Outlays	90	150	210	270	260	980
750 Administration of Justice						
End Funding for Legal Services (NDD-26)						
Budget Authority	320	340	360	380	400	1,800
Outlays	290	330	350	380	400	1,750
850 General Purpose Fiscal Assistance						
Terminate or Restrict Eligibility for General Revenue Sharing (ENT-21)						
Terminate GRS						
Budget Authority	4,550	4,800	5,000	5,250	5,550	25,150
Outlays	3,450	4,750	4,950	5,200	5,450	23,800

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
850 General Purpose Fiscal Assistance (Continued)						
Terminate or Restrict Eligibility for General Revenue Sharing (ENT-21) (Continued)						
Restrict Eligibility and Reduce Funding						
Budget Authority	1,350	1,450	1,500	1,600	1,650	7,550
Outlays	1,050	1,400	1,500	1,550	1,650	7,150
All Functions						
Correct Misclassification of General Schedule Jobs (CIV-01)						
Budget Authority	45	200	300	350	370	1,265
Outlays	40	180	280	330	350	1,180
Improve Management of Civilian Agency Activities (CIV-02)						
Budget Authority	--	180	240	250	260	930
Outlays	--	160	220	230	240	850
Reorganize Government Personnel Offices (CIV-03)						
Budget Authority	40	110	220	250	270	890
Outlays	40	100	200	230	250	820

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
All Functions (Continued)						
Modify Structure of Federal Work Force (CIV-04)						
Increase Contracting Out						
Budget Authority	60	100	210	430	640	1,440
Outlays	-25	--	30	220	390	615
Reduce Middle-Management Jobs						
Budget Authority	480	820	1,200	1,450	1,550	5,500
Outlays	430	760	1,150	1,350	1,450	5,140
Consolidate Federal Grant-in-Aid Programs (CIV-06)						
Budget Authority	20	10	230	240	270	770
Outlays	10	0	210	220	250	690
Reduce Federal Pay Adjustments for Civilian Employees (CIV-07)						
Freeze Annual Pay Adjustment in 1986						
Budget Authority	1,500	1,700	1,800	1,900	2,000	8,900
Outlays	1,500	1,800	1,900	2,000	2,100	9,300

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
All Functions (Continued)						
Reduce Federal Pay Adjustments for Civilian Employees (CIV-07) (Continued)						
Install Permanent 3-Month Delay of Annual Pay Adjustment						
Budget Authority	400	500	700	800	900	3,300
Outlays	400	500	700	800	900	3,300
Reduce Federal Travel Expenses (CIV-11)						
Budget Authority	270	290	300	325	350	1,535
Outlays	250	265	280	300	320	1,415
Alter Federal Construction Practices (CIV-12)						
Defer Construction						
Budget Authority	510	530	550	-560	-590	440
Outlays	120	290	480	370	90	1,350
Control Change Orders						
Budget Authority	160	160	170	170	180	840
Outlays	40	95	130	150	170	585

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
All Functions (Continued)						
Change Overtime Provisions for Federal Contracts (CIV-13)						
Budget Authority	510	530	560	580	600	2,780
Outlays	60	250	450	510	550	1,820
Options Not Assignable to a Function						
Raise Marginal Tax Rates for Individuals (REV-01)						
Raise Marginal Tax Rates 10 Percent						
Addition to CBO Baseline	21,100	31,100	32,100	33,100	34,200	151,600
Raise Marginal Rates 10 Percent on Income in Excess of $100,000 for Joint Filers, $70,000 for Single Filers						
Addition to CBO Baseline	2,200	5,900	6,500	7,300	8,200	30,100
Amend or Repeal Indexing of Income Tax Rates (REV-02)						
Repeal Indexing						
Addition to CBO Baseline	5,300	15,500	27,900	42,100	58,500	149,300
Delay Further Indexing Until January 1, 1987						
Addition to CBO Baseline	5,300	8,700	9,400	10,100	10,900	44,400

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Amend or Repeal Indexing of Income Tax Rates (REV-02) (Continued)						
Index for Inflation in Excess of 3 Percent						
Addition to CBO Baseline	4,300	11,600	20,100	30,000	41,500	107,500
Impose a Corporate Surtax (REV-03)						
Surtax on Tax Before Credits--10 Percent						
Addition to CBO Baseline	6,600	11,800	12,700	13,400	14,000	58,500
Surtax on Tax Before Credits--5 Percent						
Addition to CBO Baseline	3,300	5,900	6,400	6,700	7,000	29,300
Impose a Value-Added or National Sales Tax (REV-05)						
5 Percent Tax, Comprehensive Base, Effective January 1, 1987						
Addition to CBO Baseline	--	60,400	104,000	111,600	119,500	395,500
5 Percent Tax, Narrower Base, Exemptions for Food, Housing, and Medical Care, Effective January 1, 1987						
Addition to CBO Baseline	--	38,700	66,500	71,300	76,400	252,900

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Impose a Value-Added or National Sales Tax (REV-05) (Continued)						
5 Percent Tax, Narrower Base, No Exemptions for Food, Drugs, and Medical Care; Low-Income Relief Under Food Stamps and Medicaid, Effective January 1, 1987						
Addition to CBO Baseline	--	50,500	87,100	93,400	100,000	331,000
Increase Excise Taxes (REV-07)						
Extend DEFRA Increase of Telephone Excise Tax						
Addition to CBO Baseline	--	--	1,400	2,500	2,600	6,600
Extend TEFRA Increase of Cigarette Excise Tax						
Addition to CBO Baseline	1,500	1,700	1,700	1,700	1,700	8,300
Double Excise Taxes on Beer and Wine						
Addition to CBO Baseline	800	1,100	1,200	1,200	1,200	5,500
Increase Excise Taxes on Distilled Spirits						
Addition to CBO Baseline	1,100	1,600	1,600	1,600	1,600	7,500

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Increase Excise Taxes (REV-07) (Continued)						
Index Current Cigarette and Alcohol Excise Tax Rates for Inflation						
Addition to CBO Baseline	200	500	800	1,100	1,500	4,100
Restrict Deductions for Business Entertainment and Meals (REV-28)						
Addition to CBO Baseline	600	1,400	1,700	1,800	1,900	7,500
Eliminate or Reduce Itemized Deductions (REV-29)						
Allow Medical Expense Deduction Only for Costs Over 10 Percent of AGI						
Addition to CBO Baseline	400	2,500	2,800	3,100	3,500	12,300
Eliminate Deductibility of State and Local Taxes--Income Taxes						
Addition to CBO Baseline	2,900	19,800	22,300	25,300	28,500	98,800
Eliminate Deductibility of State and Local Taxes--Sales Taxes						
Addition to CBO Baseline	700	4,600	5,300	6,000	6,800	23,400

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Eliminate or Reduce Itemized Deductions (REV-29) (Continued)						
Eliminate Deductibility of State and Local Taxes--Property Taxes						
Addition to CBO Baseline	1,600	11,000	12,200	13,800	15,400	54,000
Limit Itemized Interest Deduction to $10,000 for Joint Returns ($7,500 for Others)						
Addition to CBO Baseline	600	3,800	4,400	5,100	6,000	19,900
Repeal Charitable Deduction for Nonitemizers						
Addition to CBO Baseline	400	2,800	0	0	0	3,200
Limit Itemized Charitable Deduction to Contributions Over 2 Percent of AGI						
Addition to CBO Baseline	800	5,500	5,900	6,400	6,800	25,400
Increase Audit Coverage and Expand Withholding (REV-32)						
Increase Audit Coverage						
Addition to CBO Baseline	400	1,300	2,300	2,900	3,800	10,800

SUMMARY TABLE. (Continued)

Budget Function Options	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Increase Audit Coverage and Expand Withholding (REV-32) (Continued)						
Extend Coverage of Withholding						
Addition to CBO Baseline	1,600	4,100	4,400	4,800	5,000	19,800
Reduce Tax Preferences Across the Board (REV-33)						
Addition to CBO Baseline	8,000	33,000	40,000	45,000	52,000	178,000
Expand the Existing Corporate Minimum Tax, or Replace it With an Alternative Minimum Tax (REV-34)						
Expand Base of Present Add-On Minimum Tax on Preferences						
Addition to CBO Baseline	2,200	4,300	5,700	7,600	11,500	31,300
Impose 15 Percent Alternative Minimum Tax on Comparable Base						
Addition to CBO Baseline	3,300	5,500	6,100	6,600	9.700	31,200